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THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

MARCH 6 AND APRIL 10, 1997

Serial 105–25

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
47–633 CC WASHINGTON : 1998

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[1] January 7, 1997, through April 9, 1997.
[2] Appointed April 9, 1997.

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THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT

THURSDAY, MARCH 6, 1997

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:05 a.m., in room 1100, Longworth House Office Building, Hon. Jim Bunning (Chairman of the Subcommittee) presiding.

[The advisories announcing the hearings follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SOCIAL SECURITY

FOR IMMEDIATE RELEASE CONTACT: (202) 225–9263
February 14, 1997
No. SS–1

Bunning Announces Hearing Series on "The Future of Social Security for this Generation and the Next"

Congressman Jim Bunning (R–KY), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing series on "The Future of Social Security for this Generation and the Next." The first hearing day in the series is on the report of the 1994–1996 Advisory Council on Social Security. The hearing will take place on Thursday, March 6, 1997, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be heard from invited witnesses only. Witnesses will include Advisory Council members Robert Ball, Edward Gramlich, and Sylvester Schieber. However, any individual or organization may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The Social Security program impacts the lives of nearly all Americans. This year, the Social Security Administration will pay benefits to more than 45 million retired and disabled workers and to their dependents and survivors. Nearly every worker and his or her employer pays Social Security taxes. The Social Security Board of Trustees reports annually to Congress on the financial status of the Social Security Trust Funds. In their 1996 report, the Trustees reported that Social Security spending is projected to exceed tax revenues beginning in the year 2012. By the year 2029, the Trust Funds are projected to have income sufficient to cover only 77 percent of annual expenditures. The reasons for these projections are partly demographic, including: aging "baby boomers;" declining birth rates; and increased life expectancies.

The final Advisory Council on Social Security was appointed in 1994 by the Secretary of Health and Human Services. (Under prior law, an Advisory Council was required to be appointed every four years.) The Council was asked to examine the program's long-range financial status, as well as the adequacy and equity of its benefits and the relative roles of the public and private sectors in providing retirement income. The Advisory Council issued its report January 6, 1997. The Council was unable to reach consensus, so the report includes three different approaches to restoring financial solvency.

In announcing the hearings, Chairman Bunning stated: "Social Security affects the lives of virtually every person in this country. It represents a promise, from one American to another, that we can count on each other for a more secure financial future. We must honor our promises and in doing so we owe it to every American to explore fully every possible option to ensure the future of Social Security, for this generation and the next. My aim is for all of us to listen and learn so that we can make the right decisions for Social Security's future."

FOCUS OF THE HEARING:

The Subcommittee is interested in fully exploring major areas of concern identified by the Council, along with the Council's specific findings and recommendations.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement and a 3.5-inch diskette in WordPerfect or ASCII format, with their address and date of hearing noted, by the close of business, Thursday, March 20, 1997, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Social Security office, room B–316 Rayburn House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments. At the same time written statements are submitted to the Committee, witnesses are now requested to submit their statements on a 3.5-inch diskette in WordPerfect or ASCII format.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS MEANS/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–225–1904 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SOCIAL SECURITY

FOR IMMEDIATE RELEASE CONTACT: (202) 225–9263
March 21, 1997
No. SS–2

Bunning Announces Hearing Series on "The Future of Social Security for this Generation and the Next"

Congressman Jim Bunning (R–KY), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold the second in a series of hearings on "The Future of Social Security for this Generation and the Next." At the second hearing, the Subcommittee will hear from expert witnesses who will establish a framework for evaluating options for Social Security reform. The hearing will take place on Thursday, April 10, 1997, in room B–318 of the Rayburn House Office Building, beginning at 10:00 a.m.

In view of the limited time available to hear witnesses, oral testimony will be heard from invited witnesses only. However, any individual or organization may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The Subcommittee on Social Security's first hearing in the series focused on the recommendations of the Advisory Council on Social Security. The Council offered three very different approaches to restoring Social Security's financial solvency. These proposals, along with many others, offer a wide range of options, from maintaining the program's current structure to revamping the system entirely.

As the hearings continue, the Subcommittee will assess the impact of alternative solutions to Social Security's financing problems. Members of the Subcommittee, as well as the public, want and need to gain an appreciation of the effects that changes to Social Security will have on the economy, national savings, the Federal budget, and the retirement security of every participant.

In announcing the hearing, Chairman Bunning stated: "The purpose of this hearing is to develop a background understanding of Social Security's relationship to the economy and the budget so that Members will be in a stronger position to evaluate specific proposals to ensure Social Security's future."

FOCUS OF THE HEARING:

The Subcommittee will hear the views of a wide range of experts in economics and public policy regarding the fundamental issues to consider when evaluating options for Social Security reform.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement and a 3.5-inch diskette in WordPerfect or ASCII format, with their address and date of hearing noted, by the close of business, Thursday, April 24, 1997, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Social Security office, room B–316 Rayburn House Office Building, at least one hour before the hearing begins.

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Chairman BUNNING. Good morning. First of all, I would like to welcome all the Subcommittee Members and witnesses to our first hearing of the 1997 or 105th Congress. We are especially lucky to have a number of strong newcomers to this Subcommittee. Our new Members are J.D. Hayworth from Arizona; Jerry Weller from Illinois; Kenny Hulshof of Missouri; Sandy Levin from Michigan is not a newcomer to the Full Committee but he is to this Subcommittee; Bill Jefferson of Louisiana and John Tanner of Tennessee.

I would also like to recognize a veteran of the Ways and Means Committee but a new Ranking Member for this Subcommittee, Mrs. Barbara Kennelly of Connecticut. Congratulations, Barbara. I am pleased to be working with you in this 105th Congress.

Mrs. KENNELLY. Thank you.

Chairman BUNNING. Today we kick off a series of hearings on "The Future of Social Security for this Generation and the Next." Social Security touches the lives of just about every American, and this popular, effective and vital program is facing some serious challenges. The challenges are very, very serious. In its report to Congress in 1996, the Social Security board of trustees said that Social Security spending will exceed tax revenues in the year 2012. They also project that the trust funds will only be able to pay 77 percent of benefits by 2029. In light of this outlook, it is not surprising that a much cited recent poll by the Third Millennium showed that today's youth have more faith in the existence of HMOs or UFOs—than in getting Social Security benefits. I find this disturbing and I am deeply concerned. How can we expect young people just entering the work force to feel good about contributing to a program that they view as going bust? I fear that public support for this popular program will erode even more quickly if younger workers and future generations cannot count on a reasonable return on their contributions. We just cannot let that happen.

That is why we are here to listen to the members of this final Advisory Council on Social Security. This Advisory Council was appointed by the Secretary of Health and Human Services in 1994 and charged with studying the long-range financial status of the program and presenting to Congress its plan to address the solvency problem.

I am disappointed that the council could not reach consensus and presented three plans rather than one. However, their inability to agree on a solution just proves the complexity of the issue. Since the Advisory Council released its report in January, much public debate has emerged. Engaging the public in these discussions is critical to the future of Social Security. Finding solutions is not going to be easy.

Today, we will hear from three members of the Advisory Council about their respective plans to fix the system. In the next few months, we plan to hear from policy experts, advocates, business leaders, Members of Congress, and many others. We are taking this issue seriously. We want to listen to what the people are saying, and we need to know all the facts including who is impacted by each and every proposal. We want answers, but we must be careful and thorough.

Many of you know that I have 9 children and 30 grandchildren. The future of Social Security is their future. We must step up to the challenge and to our responsibility to protect their future and the future of all Americans. In the interest of time, it is our practice to dispense with opening statements except from the Ranking Democrat Member. All Members are welcome to submit statements for the record, and I yield to Congresswoman Kennelly for any statement she wishes to make.

Mrs. KENNELLY. Thank you, Chairman Bunning, and thank you also for announcing to the public that this is only the first of a series of hearings because we all know we are going to have to study this question, listen to all points of view and get as much information as possible. But today's meeting, begins the series of hearings on the future of Social Security with testimony from members of the Social Security Advisory Council.

Gentlemen, I welcome you.

The members of the Advisory Council have offered us three distinct choices for reforming Social Security. I hope these proposals will fuel a vigorous national debate on the nature of retirement income. Such a debate is essential. It is an ingredient for action in this area. We need to be very sure we understand fully the implications of any actions we take in attempting to solve the Social Security solvency situation. The Social Security system is one of our most successful government programs. It has helped to keep older Americans out of poverty, and it has provided important protection to families suffering the death or disability of a breadwinner.

At the same time, however, we cannot avoid the demographics of the 21st century. The rise in the number of retirees due to increased life expectancy and the retirement of the baby boom generation will force us to take a hard look at our retirement policies.

I am pleased to have with us today three witnesses who have spent an incredible number of hours working on this issue, most recently as members of the Advisory Council. I know that they have crafted their recommendations, and they have thought deeply about the extent to which they think change is needed and the nature of those changes. I am particularly interested in the overall economic impact of the plans. I would like to know what our witnesses think about the need for increased national savings and the means of achieving this goal. I am also interested in the impact of the plans of these individuals and would like to hear from them about the extent to which current Social Security protections are reduced under these plans before us today.

What is the impact of an increase in the retirement age? What happens to widows, nonworking spouses, children and the disabled? What is the impact of changing a defined benefit plan into a defined contribution plan? What are the risks? Who bears these risks? I hope the presentation today will educate us on these questions and further illuminate the choices before us. Altering the Social Security system is a very serious undertaking, and we should treat it as such. I look forward to hearing from our witnesses about their plans and am hoping that we can work together to find a stable retirement for this generation and the next. Thank you, Mr. Chairman.

Chairman BUNNING. Thank you, Mrs. Kennelly. I want to inform our panel that we have a vote on the floor and we are going to recess to vote on adjourning the House, and we will be back as quickly as we can. I apologize to the panel.

[Recess.]

Chairman BUNNING. The Subcommittee will come to order. I would like now to introduce the witnesses from the Advisory Council on Social Security. Robert Ball will present supporters of the maintain benefits plan; Dr. Sylvester Schieber representing the personal security accounts plan; and Dr. Edward Gramlich, chairman of this Advisory Council, representing the individual accounts plan. Welcome to all of you, and Mr. Ball, if you would begin, I would appreciate it.

STATEMENT OF HON. ROBERT M. BALL, FOUNDING CHAIR, NATIONAL ACADEMY OF SOCIAL INSURANCE; AND MEMBER, 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY (FORMER COMMISSIONER OF SOCIAL SECURITY)

Mr. BALL. Thank you, Mr. Chairman. I think the key to the position of the six of us who support the maintained benefits (MB) plan is that we would like to restore full balance for the long-term in Social Security with the least possible change in benefit levels and in contribution rates. Our goal is not to make major or fundamental changes in the program. We think that it is quite possible and desirable—that is why we selected the name—to maintain the system much as it is today.

Now, we agree, Mr. Chairman, with your characterization in your opening remarks of there being a major and significant long-range problem. But I think there has been, particularly in the newspapers, some misunderstanding of the nature of that problem. Some of the things I read sound as if the system in a relatively short time was going to be without income and go belly up. But, as you pointed out in your opening statement, the true situation is that the program can pay full benefits on time to about 2030 under present law. And then at that point, the program does not disappear, but it has a shortfall, a significant shortfall, and is able to pay only about 75 percent of the cost of the system. But there is an important distinction between having to find financing for the whole program after 2030 or so, or whether we would be building on the continuing support of present financing for at least 75 percent of the cost of the system. Most of the support of the system comes from continuing contributions that individuals and their employees make currently, not from a trust fund, and current contributions go on after the trust fund is exhausted.

So, we are not in anything like a desperate or emergency situation. We have an important job to do soon because the sooner these problems are addressed, the less drastic the solutions have to be, but there is time, and it is not an emergency situation. Our proposal is to ask the administration and the Congress to move as quickly as is reasonable to make some common sense changes in the present program that are well within the tradition of Social Security. Later on, I will enumerate what those are. I cannot wait to take the time in this opening 5 minutes to do that.

As a result of these changes, you move the deficit from the present estimated long-term deficit of 2.17 percent of payroll down to 0.80 percent of payroll, and you move the time that the trust fund is exhausted, from about 2030 to 2050.

After that we focus on changes that I think really need public debate, more study, and evaluation. There is real reason for differences of opinion on the additional provisions that would eliminate the last 0.80 percent of payroll deficit. For example, if it is true that the cost of living has an upward bias, and that steps are going to be taken to correct that, the change in itself would go a long way to reduce that remaining 0.80 percent of payroll. I think we would all agree that we want the most accurate possible Consumer Price Index, CPI, to govern the cost of living for Social Security and there seems to be a lot of opinion that supports the idea that there is an upward bias. So to some extent, there is reason to delay the final part of the solution to the long-range imbalance until the controversy over the CPI is settled, as long as the delay is for only a year or two.

We have proposed to the administration and the Congress that this last 0.80 percent of payroll deficit be met by a mixed public/private investment policy, similar to what just about every other pension plan in the country has—that is, invest part of the accumulating funds of Social Security in the stock market, passively managed and indexed to a large part of the market. If invested up to 40 percent of Social Security funds in the stock market, you would get rid of that last 0.80 percent deficit. We think it is a good idea, but deserves more study. We are not suggesting immediate action on this. It is just enough different from what has been done in Social Security in the past that it needs some getting used to. Social Security with its huge effect on the whole nation, shouldn't be changed significantly from the past without a broad consensus. Mr. Chairman, I think probably I am close to my 5 minutes and will not start off on another subject.

[The prepared statement follows:]

Statement of Hon. Robert M. Ball, Founding Chair, National Academy of Social Insurance; and Member, 1994–1996 Advisory Council on Social Security (Former Commissioner of Social Security)

My name is Robert Ball. I was Commissioner of Social Security from 1962 to 1973. Prior to my appointment by President Kennedy, I had been the top civil servant at the Social Security Administration for about 10 years; my career at Social Security including my years as Commissioner spanned approximately 30 years. In 1948, I served as Staff Director of the Advisory Council on Social Security to the Senate Finance Committee which recommended the major changes that became the Amendments of 1950. Since leaving the government in 1973, I have continued to write and speak about Social Security and related programs. I was a member of the 1965, 1979 and 1991 statutory Advisory Councils on Social Security, and I served on the National Commission on Social Security Reform, the Greenspan Commission, upon whose recommendations the 1983 Amendments were based. I am testifying today as an individual member of the 1994–1996 Advisory Council on Social Security, but my views are shared in general by five other Council members. The views expressed are not necessarily those of any organization with which I am associated.

I. Introduction

Perhaps the single most important point to keep in mind about Social Security as we consider various options for the future is this:

Social Security is not in the emergency room and does not require heroic measures. Rather, it requires thoughtful attention to an eventual imbalance of income and expenses that begins to take effect in about 30 years. After that, unless the program is amended (as I am sure it will be), present financing would cover only about three-fourths of the cost.

The situation with Social Security is like that of homeowners living in a sound house that they very much like and that needs only to have its mortgage refinanced. There is no need to move out of the house or tear it down. The need is only to improve its long-term financing.

Six of us who served on the 1994–1996 Advisory Council on Social Security [1] propose to improve the program's long-term financing by initiating, as soon as possible, a series of common-sense measures that eliminate much of the anticipated long-term deficit. We call this approach the Maintain Benefits (MB) plan. It maintains Social Security as a defined-benefit plan, with benefits determined by law—a key point to which I will return.

The initial measures that we propose include:

- Adjusting the Cost of Living Allowance to reflect these technical corrections to the Consumer Price Index already announced by the Bureau of Labor and Statistics;
- Taxing Social Security benefits that exceed what the worker paid in, in the same way that other public and private defined-benefit pension plans are now taxed;
- Making Social Security truly universal by gradually extending coverage to those state and local government jobs that are not now covered;
- Either reducing benefits slightly—3 percent on average—by increasing, from 35 to 38 years, the wage-averaging period used to calculate benefits; or, alternatively,
- Increasing the contribution rate moderately—0.15 percent each for workers and employers;[2] and
- When Medicare is refinanced, correcting an anomaly in present law[3] so that income from taxes on Social Security benefits goes entirely to Social Security rather than to both Social Security and Medicare.

These changes reduce Social Security's projected long-term deficit by nearly two-thirds, from 2.17 percent of payroll to 0.80 percent, thus extending the life of the trust fund by two decades, from 2030 to 2050.

To close the remaining deficit and maintain Social Security in long-term balance, the options available for consideration include: gradually increasing payroll taxes; gradually increasing the retirement age or otherwise lowering projected outlays; or generating a better return on Social Security trust fund investments by diversifying them to include investing in stocks as well as in government obligations. We recommend that this last option be given very careful consideration by the Congress.

This kind of public-private investment strategy—the same strategy used by other pension systems—would permit Social Security, while continuing to invest primarily in Treasury securities, to invest part of the accumulating trust fund surplus in a passively managed portfolio of stocks indexed to the broad market.

This investment approach has many advantages over the two proposals advanced by other members of the Advisory Council to break up Social Security into millions of individual retirement savings accounts. Most importantly, it preserves Social Security as a defined-benefit plan, in which benefits are determined by law rather than by what happens to an individual's savings account.

That is a fundamentally important safeguard for a system designed, as Social Security is, to provide a secure base on which to plan and build one's retirement. If the base itself is made less secure—by replacing it with millions of relatively small individual accounts, all subject to the vagaries of individual investment decisions and unduly dependent on the performance of the stock market—Americans will have lost the universal system of basic economic security that we have been building so carefully and successfully for 60 years. Instead of refinancing the mortgage, we will have undermined the house.

Whatever the President and the Congress decide to do with Social Security in the future, we should not seriously consider trading part of it for high-cost social experiments that put all Americans at risk. In our view, the Social Security Advisory Council did not produce three viable options from which to choose. The six of us could not, under any foreseeable circumstances, support either of the two private-retirement-accounts proposals, and we do not believe that most Americans will find them even remotely attractive, once the risks, costs, and trade-offs are fully understood.

II. Social Security: America's Family Protection Plan

For 60 years the United States has pursued a three-tier retirement income policy consisting of Social Security and two supplementary tiers: employer-sponsored pensions, now covering about half the work force, and voluntary individual savings. Each tier complements the others and has become a fixed feature of national policy. Social Security, covering nearly everyone, is a contributory, wage-related, defined-benefit plan administered by the Federal government and entirely supported by dedicated Federal taxes, and the two supplementary tiers are explicitly encouraged by Federal tax policy.

Social Security, the basis of this three-tier structure, has been a uniquely successful program by any measure. For more than half a century, it has been America's family protection plan, providing millions of the elderly and disabled with secure incomes, guarding them against impoverishment, and relieving their children and grandchildren of what could easily become the unmanageable burden of supporting them year in and year out throughout their old age.

No program has ever done more to alleviate and prevent poverty or to protect income against erosion by inflation. None has done more to protect children against the risk of impoverishment when a wage-earning parent dies or becomes disabled. And no program has ever enjoyed greater public support.

Several key points about Social Security need to be kept in mind, particularly when considering proposals that would have the effect of replacing or substantially altering it:

• Social Security provides a basic income floor for virtually all working Americans at the time of retirement, allowing millions of the elderly to maintain their independence. It provides $12 trillion in life insurance protection, more than all private insurance combined. More than 43 million Americans are currently receiving benefits—including 27 million retirees, 11 million family members and survivors of deceased workers (including 3 million children under 18) and 5 million disabled persons.

• Social Security is self-supporting and has not added a penny to the deficit. Since 1937 the program has collected $5 trillion and paid out $4.5 trillion, leaving $500 billion in reserve.

• Social Security is highly efficient and has very low administrative costs. Administrative expenses consume less than one percent of revenues, compared to 11 percent on average (not including profit) for private insurance.

• With fewer than half of all U.S. workers currently covered by private pension plans, the majority of retired Americans find themselves relying on Social Security for most of their income. Without Social Security, nearly one of every two elderly Americans would fall below the poverty line.

• Social Security benefits and inflation adjustments have been of crucial importance in reducing poverty among older Americans. Thirty years ago, poverty among the elderly was more than twice the national rate. Today the poverty rate among the elderly is under 12 percent, comparable to other adults.

• Social Security provides substantial protection for survivors and those with disabilities. For a typical example—a 27-year-old couple, both working at average wages, with two small children—survivors' protection is worth $307,000. Disability protection for the same family amounts to $207,000.

Social Security is, in other words, a program of many parts: part retirement program, part disability income program, part life-insurance program, part anti-poverty program—and all of them working together for the benefit of the nation. Even if some individuals were able to do better under an individualized retirement savings scheme, the nation as a whole would not be better off.

It is also important to understand that although Social Security does require financial strengthening to meet its full obligations over the 75-year period for which Social Security forecasting is done, the program does not face a financial crisis—now or tomorrow.

Even with no changes in present contribution rates and benefits, Social Security can continue to pay full benefits on time for 30 years, and after that could still pay 75 percent of its obligations. Even 75 years from now, without any change in law, Social Security could still meet 70 percent of its obligations. Our task, in other words, is not to overcome a crisis but to make up a shortfall.

In 1995, the Trustees of Social Security estimated that over the long run—that is, over the course of the 75-year estimating period—outlays are expected to exceed revenues by 2.17 percent of total covered payrolls. In other words, if Social Security contribution rates had been increased by 2.17 percentage points in 1995, the long-term deficit would be eliminated. This is not to suggest that a contribution-rate increase in 1995 would have been a good idea, but simply to show that the shortfall on the horizon is not of such magnitude as to require radical solutions. Moderate measures, undertaken soon, can avert major problems later, in much the same way that a minor course correction can steer a ship safely past a hazard on the horizon.

The long-term imbalance of revenues and expenses can be substantially reduced by taking several common-sense steps. These options are discussed in Social Security for the 21st Century: A Strategy to Maintain Benefits and Strengthen America's Family Protection Plan, our statement in the report of the Advisory Council, and are summarized below:

Proposed Change	Rationale for Change	Impact on 2.17% Deficit[4]
1. Increase taxation of benefits	Benefits should be taxed to the extent they exceed what the worker paid in, as is done with other defined-benefit pension plans..	−0.31
2. Change Cost of Living Adjustment (COLA) to reflect corrections to Consumer Price Index (CPI) announced in 1996 by Bureau of Labor Statistics.	COLA is determined by CPI, which is widely believed to overstate inflation; further changes to CPI may be made, perhaps affecting COLA—and thus the long-term deficit—more than shown here..	−0.31
3. Extend Social Security coverage to all newly hired state and local employees.	Most state and local employees are already covered; the 3.7 million who are not are the last major group in labor force not covered..	−0.22
4. Change wage-averaging period for benefits-computation purposes from 35 to 38 years, or increase contribution rate 0.3% (0.15% for workers and employers alike).	Helps bring program into long-term balance by reducing benefits (3% on average) for future retirees. Increase would have approximately the same effect on deficit as 3% benefit cut..	−0.28
5. Redirect income from taxes on Social Security benefits from Medicare to Social Security[5].	Corrects anomaly in current law. Note: This change to go into effect when Medicare is refinanced (2010–2020).	−0.31

Long-term deficit remaining after implementation of above changes: 0.80%[6]

The Advisory Council agreed that this package of relatively modest changes reduces Social Security's anticipated long-term deficit by nearly two-thirds, extending the life of the trust funds from 2030 to 2050. That being the case, there simply is no compelling argument for abandoning the traditional Social Security program, with its unique advantages, for a radical experiment with individual retirement savings accounts. Yet that is the approach proposed by various Advisory Council members.

II. 'Individual Accounts' (IA)

The Individual Accounts (IA) plan proposed by two members of the Council would:

(1) Reduce existing Social Security protection so that over the long run benefits are brought into balance with the current combined contribution rate (12.4 percent of payroll); and

(2) Establish a new compulsory individual savings plan, financed by an additional 1.6 percent deduction from workers' earnings, raising the worker's deduction from 6.2 percent of earnings to 7.8 percent beginning in 1998.

Benefits under the Social Security part of the plan would be gradually reduced, ultimately cutting benefits about 30 percent on average. This results in part from accelerating the increase in the normal retirement age (NRA) scheduled in present law and then continuing to increase it by indexing it to longevity, and in part by changing the wage-averaging and benefit formulas. The reduction in benefits would be gradual but substantial.

Proponents argue that the IA plan, on average, is designed to protect the status quo for Social Security participants by bringing the combined benefits of the reduced Social Security system and the new savings plan up to the level now provided for (but not fully funded) by the present Social Security system. However, the IA plan has many flaws:

- It reduces Social Security's defined guaranteed benefit plan in the long run by 30 percent for the average worker (32 percent for higher-paid and 22 percent for lower-paid workers), with the hope that the average return on savings in individual accounts will make up for the losses in Social Security benefits. But even if this turns out to be the case on average, many will fall below average, particularly among the lower-paid.
- It requires all workers to set aside more of their wages than at present—in effect a tax increase—with the increase required to be saved for retirement, regardless of other more immediate needs that the worker and his or her family may have for health care, emergencies, or more basic needs such as food, clothing and shelter.

• It makes the challenge of solving Medicare's financial problems more difficult by pre-empting compulsory deductions from workers' earnings for retirement savings rather than for health care. If a payroll-tax increase is to be considered, there is a more immediate need to direct such income to Medicare than to Social Security.

• It undermines broad public support for the residual Social Security system by producing lower and lower benefits, which in turn will create pressure from the more successful savers and investors to shift more of their payroll taxes from Social Security to private accounts.

• Even on average, it is unlikely to achieve the goal of adequate retirement income because many savings accounts holders will face more immediate needs and will want access to their money before retirement, and there will be great pressure on the Congress to authorize early withdrawals. After all, the selling point for these private accounts is that the money belongs to the individual. Individuals facing emergencies or other major expenses will not take kindly to being told that they must wait for many years to gain access to their funds.

For all of these reasons (discussed at greater length in our statement in the report of the Advisory Council), the six of us strongly oppose the IA plan. Indeed, we see the IA plan as something of a Trojan horse, in effect if not in intent, because it could result in undermining support for what would remain of the traditional Social Security program, thus leading to even greater substitution of a private savings scheme for social insurance.

III. Personal Security Accounts (PSAs)

The Personal Security Accounts (PSA) plan proposed by five members of the Advisory Council would:

(1) Replace Social Security's existing benefits structure with a flat monthly government-paid retirement benefit varying only with length of time worked;

(2) Create a system of compulsory private individual "security accounts" (i.e., savings accounts) for retirement, funded by 5 percentage points of the payroll tax now going to Social Security.

The monthly benefit payable via the government system would be $205 after 10 years of coverage (in 1996 dollars, wage-indexed thereafter), rising by about $8 for each additional year of coverage until the maximum benefit—$410 a month—is reached for workers having 35 years of coverage. Spouses of eligible workers would receive a monthly benefit of $205, and older surviving spouses would get 75 percent of the total flat benefit payable to the couple. A disability and young survivor's program similar to the present system (but ultimately reduced by 30 percent in the case of disability) would also be part of the central government system.

The PSA plan requires increasing the payroll tax by 1.52 percentage points beginning in 1998 and continuing through 2069. In addition, the plan would borrow from the Federal government over 33 years—at the peak owing the Treasury about $2 trillion (in 1996 dollars, $15 trillion in then-current dollars) and then repaying it over the next 35 years. The tax increase and the borrowing are necessary to enable the plan to fulfill the benefit promises of the present Social Security system for those 55 and older, and to pay for past service credits from the present system to those 25 to 54. All those now under 25 would, at retirement, receive only the flat benefit plus whatever the 5 percent of wages invested in PSAs added up to.

Individuals would be free to invest their PSAs in any generally available financial instrument, and the accumulated amounts would become available when they reached retirement age, with no requirement for annuitization and with no special provision for spouses or other dependents.

The PSA approach has all the disadvantages of the IA plan—and more:

• It requires a 1.52 percentage point increase in the payroll tax for 72 years, and, in addition, massive borrowing from the Federal government.

• The residual public Social Security program becomes even more unattractive to most contributors than in the case of the IA plan, with benefits related only to the length of time under the system. Thus, regardless of wage levels or what was paid in, the maximum benefit is only $410 a month (about two-thirds of the poverty level) for someone who has paid into the program for 35 years.

• Investment choices are essentially unrestricted (and thus difficult to monitor) and the payout at retirement age could be in a lump sum, with no annuity requirement to spread payments out over the retirement years—and no inflation protection.

• The more successful investors would have little reason to want to keep what is left of the public system, and without their political support it would probably be phased out or converted into a means-tested poverty program.

• The plan increases the Federal budget deficit by $200 to $300 billion a year for the next three decades. Moreover, with some investors failing to get good returns, the burden on the government (read: taxpayers) would in all likelihood be greater, because many retirees facing impoverishment would be forced to turn to means-tested income-support programs such as Supplemental Security Income (SSI), thus driving up the cost of these taxpayer-supported programs.

• The plan is particularly harsh on those with disabilities and on those spouses who do not have sizeable accounts of their own (as discussed in our statement in the report of the Advisory Council).

• The communication and administrative tasks created by the plan, particularly during the "transition" period (more than 70 years), seem overwhelming. The government would have to explain the protection being provided under present Social Security law and the new flat benefit program as it will be for the young, while explaining the rules governing how much one gets from each source during the transition. Administratively, the government would have to keep an eye on small as well as large employers to make sure not only that deductions are made from wages each payday but that they are deposited in the employee's choice of a bank, broker, or other financial agent. Then the government must make sure that the accumulating funds are kept intact—through all subsequent movements of the varying totals among changing fiscal agents—until retirement. This would be a monumental task. As noted previously, the administrative costs of the present Social Security system are below one percent. In contrast, the administrative costs of Chile's privatized retirement system—which offers fewer options than would be available under the PSA plan—are reportedly in the range of 15 percent.

• The plan violates the basic principle of pooling resources and spreading the risk that has helped Social Security to weather economic downturns and recessions and that makes it feasible to distribute retirement income equitably. Instead of sharing risks, workers would have to bear risk individually—with the certainty that some risks would turn out very badly, and that in such cases (typically people outliving their savings accounts), retirees would have to turn to their adult children or to means-tested income-support programs for help.

• The plan fails the test of cost-effectiveness. If we want to increase returns on investment of Social Security funds—both to completely close the remaining long-term deficit discussed above and to make Social Security a more attractive 'investment' for younger workers—it would make far more sense to centrally invest a portion of the trust funds in private equities, as is done now by virtually all other federal, state, local, and private-sector defined-benefit retirement plans. With this approach, administrative costs are much lower and net overall returns are thus higher.

The IA plan and the PSA plan have their differences, but what they have in common is that both, in the guise of rescuing Social Security, require radical and unnecessary "reforms" that would mean new risks and higher costs for workers and retirees.

• They require workers to pay twice for retirement: once to keep the present system solvent enough to pay at least reduced benefits to present beneficiaries and those workers who will be retiring soon, and once to fund the new system of individual retirement accounts.

• They require major new tax increases. The IA plan increases workers' deductions (workers only—no matching increase for employers) from 6.2 percent to 7.8 percent of payroll; the PSA plan increases the combined worker-employer rate by 1.52 percentage points while simultaneously borrowing more than $2 trillion from the Treasury. These are burdens that would begin now and accumulate for decades.

• They undermine public confidence in Social Security, even in its "reformed" version, by requiring substantial cuts in government-paid benefits, thus making some private investment accounts appear to be more attractive.

• They assume that workers will, on average, be able to offset reduced benefits—and come out ahead—by earning higher returns on their private investments. But of course there are no guarantees. A skillful or lucky investor may indeed do well; an unlucky investor could end up with much less than the benefits that would have been guaranteed in law under the present system. Averages being averages, it is a certainty that many would earn below-average returns.

None of this is necessary. The six of us who propose the Maintain Benefits plan believe that our first task is to take the common-sense steps outlined above (and discussed in our statement in the Council report) and this greatly reduces Social Security's long-term deficit right away. At the same we propose exploration of the various options to bring the program into full long term balance.

There are several such options, including: enacting, in the near future, moderate tax increases or benefit cuts for future retirees; scheduling further increases in the normal retirement age (which has the same effect on Social Security's long-term deficit as reducing benefits, and which some would argue may be justified by increases in longevity); or scheduling a series of future increases in contribution rates. All of these options have disadvantages, however, including making Social Security less attractive to younger workers by lowering the ratio of benefits to contributions. This strengthens the case for exploring the pros and cons of a public-private investment strategy.

IV. A Public-Private Investment Strategy

The six of us who advocate the Maintain Benefits plan also advocate reviewing Social Security's present investment policy. Under present law, funds may be invested only in low-yield government bonds. Yet funds are accumulating in anticipation of the demands on the system that will be made when the baby-boom generation begins retiring in the second decade of the 21st century. Investing up to 40 percent of this accumulating "surplus" in stocks indexed to the broad market would yield higher returns, closing the remaining long-term deficit while also improving the benefit/contribution ratio for younger workers.[7]

The objective of investment neutrality can be established in law and pursued as a matter of policy by establishing an expert board (as in the case of the Federal Retirement Thrift Investment Board, which administers the Thrift Savings Plan for Federal employees) to select an appropriate passive market index, choose portfolio managers, and monitor portfolio management.

Some critics of this investment strategy argue that politicians would be tempted to tamper with the index of government investments in order to steer investments toward preferred social objectives. In reality this is unlikely to be a problem. Once the objective of investment neutrality is set, we can be reasonably confident that our competitive political system will furnish the necessary checks and balances to protect this principle. Efforts by one party to undermine neutrality would provide a major point of attack for the other party, with the result that future Congresses would be reluctant to interfere with an established investment arrangement in which nearly every American family would have a stake. (This is the same principal of political balance that has thus far protected Social Security from radical change.)

Perhaps foremost among all the advantages of this approach over the IA and PSA plans is that it preserves Social Security as a defined-benefit plan, with benefits determined by law rather than by the uncertainties of individual investment decisions. In all respects, it leaves the essential principles of the traditional Social Security system undisturbed while restoring long-term balance and offering Social Security participants the same investment benefits that are enjoyed by participants in other large retirement plans—state, local, and private. The investment risk is kept manageable and affordable by investing as a group rather than as individuals, and the administrative costs are, of course, very low in comparison to making investments at retail and managing millions of relatively small individual accounts.

V. Conclusion

Today Social Security fulfills what Lincoln described as "the legitimate object" of government: "to do for a community of people whatever they need to have done but cannot do at all or cannot do so well for themselves in their separate and individual capacities." It is extremely important that Social Security, as the basis for all retirement planning, continue in the form of a defined-benefit plan, promising specified benefits that are not at risk of being undermined by investment decisions.

With Social Security as a base to build on, those who can afford to accumulate other retirement income are free to do so, with encouragement from the tax code and without being penalized by a means test. And, with basic Social Security protection in place, pension plans and private investors can more freely take risks in pursuit of higher investment returns.

This argues for retaining Social Security as the basic foundation of our traditional three-tier retirement system—a foundation that is not threatened by the failure of a business or the decline of an industry, and with benefits continuing to be defined by law. Over time, of course, Social Security has adapted to change and can continue to do so, even as we are now recommending. But the system that has met every challenge for 60 years has proven sound—and continues to merit powerful public support.

Whenever Social Security's long-term stability has been threatened by circumstances warranting a legislative response, strong public support for the program has encouraged political leaders to seek bipartisan solutions that build on Social Security's inherent strengths. That is the approach we recommend now—to build on rather than replace the family protection plan that works so well for so many.

NOTES

1. Robert M. Ball, Edith U. Fierst, Gloria T. Johnson, Thomas W. Jones, George Kourpias, and Gerald M. Shea.
2. Council Member Edith U. Fierst would prefer not to implement either of these changes; see her statement appended to the main report of the Advisory Council.
3. Some of the revenue from taxation of Social Security benefits now goes to the Medicare Hospital Insurance (HI) trust fund, not as a matter of policy but for reasons related to Senate voting procedures (see the report of the Advisory Council, p. 78), and this anomaly should be corrected when Medicare is refinanced.
4. Estimates by the Office of the Actuary, Social Security Administration.
5. This is the only one of these proposals not supported by a majority of the Advisory Council.
6. Adjusted for interaction of proposed changes (see the report of the Advisory Council, p. 80).
7. To help maintain the program in balance even beyond the traditional 75-year estimating period, a contribution-rate increase of 1.6 percent should be scheduled to go into effect in 2045, with the understanding that at that time, depending on actual experience, the increase may not be needed (see the report of the Advisory Council, p. 86, for a discussion of this issue).

Chairman BUNNING. Your time did expire.

Dr. Gramlich, would you please make your presentation.

STATEMENT OF EDWARD M. GRAMLICH, PH.D., DEAN, SCHOOL OF PUBLIC POLICY, UNIVERSITY OF MICHIGAN; AND CHAIR, 1996 QUADRENNIAL ADVISORY COUNCIL ON SOCIAL SECURITY

Mr. GRAMLICH. Thank you for soliciting my testimony on Social Security reform, Mr. Chairman. In trying to reform this important program that has worked so well now for 60 years, I am guided by three goals. The first is to retain the important social protections of this program that has reduced poverty and the human costs of work disabilities. The second is to make the social protections affordable by bringing Social Security back into long-term financial balance. The third is to add new national saving for retirement, both to help individuals maintain their own standard of living in retirement and to build up the Nation's capital stock in advance of the baby boom retirement crunch.

In the recently released report of the Advisory Council, I have introduced a compromise plan called the individual accounts, IA, plan that tries to achieve all three goals. It would preserve the important social protections of Social Security and still achieve long-term financial balance in the system by what might be called kind and gentle benefit cuts. Most of the cuts would be felt by high-wage workers with disabled and low-wage workers being largely protected from the cuts. Unlike the other two plans proposed by the Advisory Council, there would be no reliance at all on the stock market for these benefits and no worsening of the finances of the Health Insurance Trust Fund.

The IA plan would include some technical changes such as including all state and local new hires in Social Security and applying consistent income tax treatment to Social Security benefits. These changes are also part of the Council's other plans and go some way to eliminating Social Security's actuarial deficit.

Then, beginning in the 21st century, the changes would be supplemented with two other measures. There would be a slight increase in the normal retirement age for all workers. There would be a slight change in the benefit formula to reduce the growth of Social Security benefits for high-wage workers. Both of these changes would be phased in very gradually to avoid actual benefit cuts for present retirees and to avoid notches in the benefit schedule, which are instances when younger workers with the same earnings records get lower real benefits than older workers. The result of all changes would be a modest reduction in the overall real growth of Social Security benefits. When combined with the rising number of retirees, the share of the Nation's output devoted to Social Security spending would be approximately the same as at present, eliminating this part of the impending explosion in future entitlement spending. Of the three plans suggested by our Council, my plan is clearly the best for achieving short- and long-term balance in the Federal budget.

These benefit cuts alone would mean that high wage workers would not be experiencing rising real benefits as their real wages grow, so I would supplement these changes with another measure to raise overall retirement and national saving. Workers would be required to contribute an extra 1.6 percent of their pay to their individual accounts. These accounts would be owned by workers but centrally managed. Workers would be able to allocate their funds among five to ten broad mutual funds covering stocks and bonds. Central management of the funds would cut down the risk that the funds would be invested unwisely, would cut administrative costs, and would mean that Wall Street firms would not find these individual accounts a financial bonanza. The funds would be converted to real annuities on retirement to protect against inflation and the chance that retirees would overspend in their early retirement years.

All changes together would mean that approximately the presently scheduled level of benefits would be paid to all wage classes of workers of all ages. The difference between this outcome and present law is under this plan, these benefits would be affordable, as they are not under present law. The changes would eliminate Social Security's long-term financial deficit while still holding together the important retirement safety net provided by Social Security. They would reduce the growth of entitlement spending and improve the Federal budget outlook. They would significantly raise the return on invested contributions for younger workers, and the changes would move beyond the present pay-as-you-go financing scheme by building up the Nation's capital stock in advance of the baby boom retirement crush.

As the Congress debates Social Security reform, I hope it will keep all of these goals in mind, and I hope also that it will make these types of changes in this very important program.

Thank you very much for hearing me.

[The prepared statement follows:]

Statement of Edward M. Gramlich, Ph.D., Dean, School of Public Policy, University of Michigan; and Chair, 1996 Advisory Council on Social Security

Thank you for soliciting my testimony on Social Security reform, Mr. Chairman. In trying to reform this important program that has worked so well now for sixty years, I am guided by three goals. The first is to retain the important social protections of this program that has greatly reduced aged poverty and the human costs of work disabilities. The second is to make these social protections affordable by bringing Social Security back into long term financial balance. The third is to add new national saving for retirement—both to help individuals maintain their own standard of living in retirement and to build up the nation's capital stock in advance of the baby boom retirement crunch.

In the recently released report of the Advisory Council, I have introduced a compromise plan, called the Individual Accounts Plan (IAP), that tries to achieve all three goals. It would preserve the important social protections of Social Security and still achieve long term financial balance in the system by what might be called kind and gentle benefit cuts. Most of the cuts would be felt by high wage workers, with disabled and low wage workers being largely protected from cuts. Unlike the other two plans proposed by the Advisory Council, there would be no reliance at all on the stock market for these benefits, and no worsening of the finances of the Health Insurance Trust Fund.

The IA plan would include some technical changes such as including all state and local new hires in Social Security and applying consistent income tax treatment to Social Security benefits. These changes are also part of the Council's other plans, and go some way to eliminating Social Security's actuarial deficit.

Then, beginning in the 21st century, the changes would be supplemented with two other measures. There would be a slight increase in the normal retirement age for all workers. There would also be a slight change in the benefit formula to reduce the growth of Social Security benefits for high wage workers. Both of these changes would be phased in very gradually to avoid actual benefit cuts for present retirees and notches in the benefit schedule (instances when younger workers with the same earnings records get lower real benefits than older workers). The result of all changes would be a modest reduction in the overall real growth of Social Security benefits. When combined with the rising number of retirees, the share of the nation's output devoted to Social Security spending would be approximately the same as at present, eliminating this part of the impending explosion in future entitlement spending. Of the three plans suggested by our Council, my plan is clearly the best for achieving short and long term balance in the federal budget.

These benefit cuts alone would mean that high wage workers would not be experiencing rising real benefits as their real wages grow, so I would supplement these changes with another measure to raise overall retirement (and national) saving. Workers would be required to contribute an extra 1.6 percent of their pay to their individual accounts. These accounts would be owned by workers but centrally managed. Workers would be able to allocate their funds among five to ten broad mutual funds covering stocks and bonds. Central management of the funds would cut down the risk that funds would be be invested unwisely, would cut administrative costs, and would mean that Wall Street firms would not find these individual accounts a financial bonanza. The funds would be converted to real annuities on retirement, to protect against inflation and the chance that retirees would overspend in their early retirement years.

All changes together would mean that approximately the presently scheduled level of benefits would be paid to all wage classes of workers, of all ages. The difference between this outcome and present law is that under this plan these benefits would be affordable, as they are not under present law. The changes would eliminate Social Security's long term financial deficit while still holding together the important retirement safety net provided by Social Security. They would reduce the growth of entitlement spending and improve the federal budget outlook. They would significantly raise the return on invested contributions for younger workers. And, the changes would move beyond the present pay-as-you-go financing scheme, by building up the nation's capital stock in advance of the baby boom retirement crunch.

As the Congress debates Social Security reform, I hope it will keep all of these goals in mind. I also hope it will make these types of changes in this very important program. Thank you for hearing me.

Chairman BUNNING. Dr. Schieber.

STATEMENT OF SYLVESTER J. SCHIEBER, PH.D., VICE PRESIDENT, WATSON WYATT WORLDWIDE; AND MEMBER, 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY

Mr. SCHIEBER. Thank you. Mr. Chairman, thank you for the opportunity to testify before you today to relate to you my perspective on the deliberations of the Social Security Advisory Council, and the proposal calling for the creation of personal security accounts, PSA, is the best way to reform the program. Social Security's own trustees have been telling us for some time that the program is significantly underfunded for future generations. If the full imbalance were addressed immediately through a tax increase, it would increase cost rates by about 20 percent over the next 75 years.

Given current tax burdens, such an increase is no trivial matter. In addition, by the time we get around to dealing with Social Security's financing problems, the current funding gap will be much larger than it is today. The potential rededication of 2 percent of gross domestic product, GDP, to provide old-age, survivors, disability insurance, OASDI, benefits might be tenable if that were the only imbalance that the Government were facing. But as we all know, it is not. For reasons outlined in my prepared remarks, Medicare's claim on the economy is going to be much harder to reduce or stabilize than Social Security's.

We have to consider rebalancing Social Security in the larger context of the total Federal Government claim on the economy and within the context of other entitlements that must be financed out of government revenues. It does not make any difference that there is a separate earmarked tax that finances Social Security. There is only so much that the public is willing to give to the Government, and there are other things that the Government has to do.

In the Advisory Council's deliberations, there was virtually no support for a straightforward increase in the payroll tax to rebalance the current system. We spent much time looking for ways to live within the current tax rates, but in the final analysis, there was little support for that option either. The unwillingness to raise taxes or cut benefits in a straightforward manner drove us all to consider policy options not previously viable, but we split into three camps in terms of the particular policy options that we supported.

The members of the council that I sided with, five of us, advocated significant reorganization of the current system. We proposed that 2.4 percent of covered payroll that now finances disability and young survivor benefits should continue to be financed through Social Security. The employer's portion of the remaining payroll tax, 5 percent of covered payroll, would finance a flat benefit payable to all long career workers. The employee's remaining 5 percent would go into personal security accounts managed like 401(k) or IRA assets. The combination of scaled-down Social Security benefits plus the personal security account or PSA benefit would be similar to benefits provided by current law.

Critics of the PSA proposal argue that it would erode public support for the redistributive aspects of Social Security. Since the PSA system would have the same overall benefit structure as current law, this opposition would only arise because workers might understand the program's redistribution work more clearly than they do under current law, but it is likely that most workers already understand the current system, either on their own or because many commentators have told them how it works. Furthermore, if the only way we can get the public to support such a program is to confuse them about how it works, the program is not sustainable anyway.

Critics of the PSA plan also argue it would expose workers to undue risk in the financial markets. This argument often paints a picture of individual account plans creating risks for workers where none exists in the current environment. As I point out in my prepared remarks, the 1977 Social Security amendments reduce many workers' Social Security relatively more than the October 1987 stock market crash. Today, Social Security is significantly underfunded, and to restore balance, benefits must be cut or taxes raised to finance current promises. Either of these propose significant risks. Critics of the PSA proposal finally argue that it would create tremendous new obligations for future taxpayers. The reason that this argument is given any credence is because the Government does not consistently account for its future obligations.

Table 1 in my prepared remarks shows that the Advisory Council proposal that most significantly reduces the long-term Government obligations of Federal taxpayers is the PSA plan. Considering the full projected costs of the transition including any borrowing, the PSA proposal reduces total future taxpayer obligations nearly twice as much as the individual accounts proposal. It reduces them by more than 20 times the MB proposal's cost reductions. It is the only proposal that would reduce the claim that OASDI payments by the Government would make on the overall economy.

While several members of our Advisory Council and others have branded the PSA proposal radical, I suggest that we look at the world around us to see that such proposals are commonplace. Reforms of this sort are sweeping across Latin America. Similar reforms have been adopted in a number of countries in the Australasian sphere of the world. They have been implemented in United Kingdom and are being considered across other countries of Europe. What is radical about the PSA proposal is that it would create an opportunity to turn our national retirement program into a system that would begin to fund its benefits promises by adding to savings of our economy. We believe it would also restore confidence in a system that the majority of taxpayers today believe will not deliver the benefits that are being politically promised.

Thank you very much.

[The prepared statement and attachments follow:]

Statement of Sylvester J. Schieber, Ph.D., Vice President, Watson Wyatt Worldwide; and Member, 1994–1996 Advisory Council on Social Security

The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

Social Security's actuaries and trustees have been telling us for some time that the program is significantly underfunded for future generations of retirees. Some students of the program trivialize its underfunding by saying that it is only underfunded by 2.2 percent of covered payroll over the next 75 years and imply that its imbalance is no big deal. That is very misleading. If the actuarial imbalance is to be made up through a tax increase, it would be an 18 percent increase in the program's cost over the next 75 years. Such an increase in the tax that has become the largest federal tax for many workers is no trivial matter.

In addition, the 2.2 percent figure assumes that we could have raised the payroll tax rate 2.2 percentage points early last year and banked the added accumulation, or cut benefits by a comparable amount. There are three problems with such an assumption. First, the 2.2 percentage points understates the actuarial imbalance because the actuaries do not consider the deteriorating funding status of the program at the end of their 75-year projection period. If we wanted to raise enough revenues to make up for this calculation period problem, we would have had to raise the payroll tax 2.5 percentage points early last year. Second, after the experience of the ballooning federal debt in conjunction with the trust fund accumulations of the last 14 years there are questions about the government's ability to convert added payroll tax collections into national savings. Third, policymakers have not been willing to raise taxes by the 2.2 percentage points, or the more realistic 2.5 points, needed last year or to cut benefits immediately by a corresponding amount. By the time we get around to dealing with Social Security's financing problems, the 2.2 percent or 2.5 percent funding gap will be much larger than it is currently. If we wait until the baby boomers are retired to deal with this problem, the actuarial imbalance will have doubled from its current level.

It is important that Congress deal with Social Security's financing imbalance soon because it damages the public's perception about the long-term viability of the program. Some people dismiss reports that the majority of workers under age 50 believe they will not get full benefits now provided by Social Security when they retire as public cynicism. I believe that while most people do not understand the arcane nuances of Social Security financing, many of them do catch the yearly news reports telling of the annual release of the Trustees Report. The headlines generated last year by that report indicated that Social Security would run out of money in 2029—that is, within the normal life expectancy of virtually all workers under age 50 today. Is it cynicism that people believe their government's reports of the program running out of money in their lifetime means they will get reduced benefits? I think not.

In considering policies to deal with Social Security's actuarial imbalances, Congress cannot ignore the larger context of the government's total fiscal operations. It also has to keep in mind the provision of retirement security to workers while maintaining some modicum of equity across generations. Balancing the various goals is no easy task. It was this combination of considerations that drove the members of the Social Security Advisory Council in very different directions in proposing solutions to its current imbalances in the system.

Balancing Social Security in the Larger Context of Federal Fiscal Operations

Figure 1 shows three-year averages of the total receipts of the federal government as a percentage of gross domestic product (GDP) starting with Fiscal Year 1951 through Fiscal Year 1996. I use three-year averages rather than the actual annual data to smooth the effects of economic cycles on tax revenues. Over this 45 year period, total receipts varied from a low of 17.1 percent of GDP to a high of 19.3 percent, only about a 2 percentage point variation in the claim that the federal government has made on taxpayers. While there is no natural limit to government's claim on the economy, there are clearly political forces that narrowly limit the amount US taxpayers are willing to render to it. Even looking at actual year-to-year numbers, the maximum claim in any year was 19.7 percent of GDP.

Under current law, OASDI claims are expected to grow from 4.7 percent of GDP in 1996 to 6.5 percent by 2035. If we begin with an assumption that total government claims on the economy are narrowly limited and that Social Security is scheduled to make a bigger claim than currently, then some other government expenditures must shrink. One way to look at the potential for Social Security's claim to expand while other programs contract is to look at it in the context developed by the Entitlement Commission during 1994.

The Commission looked at the potential total claim that all entitlement programs would make on the government as presented in Figure 2.[1] Entitlements include Social Security, Medicare, retirement programs for federal civilian and military retirees, Medicaid, and various other means tested welfare programs. Social Security and Medicare make up about two-thirds of total entitlement claims today. By 2030, entitlement claims alone are projected to exceed the 17 to 19 percent of GDP that taxpayers have been willing to share with government over the latter half of the 20th century. Indeed, the programs aimed at the elderly alone are expected to exceed that amount by 2030. The predicament predicted in Figure 2 suggests that expanding Social Security's claim on the US economy might be more difficult than simply bringing its own accounts back into actuarial balance.

Figure 3 dissects the projected increases in total entitlement claims into three component parts, namely Social Security, Medicare, and other entitlement pro-

[1] In these projections, Medicare and Social Security outlays follow the Medicare and Social Security Trustees' best estimates. Medicaid outlays are assumed to reflect demographic changes and the increases in health care costs that underlie the Medicare projections. All other spending and revenues are assumed to follow Congressional Budget Office projections through 1999 and to grow in proportion to the overall economy thereafter.

grams. While each of the component elements is projected to grow, the graphic suggests that the most significant contributor to the expected growth in total entitlements is expected to be the Medicare program. In the case of the other entitlements, the growth of Medicaid is a major contributor in projected growth. This leads some policy analysts to argue that our entitlement problem is really a Medicare and Medicaid problem rather than one with the cash programs that are included under the entitlement umbrella. They claim that if we can restrain the rapid growth in the health care programs, we can sustain projected growth in the cash programs.

One problem in constraining federal health programs for the elderly is that doing so is likely to be more difficult than constraining the cash programs for retirees. There are several reasons for this. First among them is that old people simply use more health care services than younger ones as shown in the left-hand panel of Figure 4. The right hand figure shows that the percentage of our population over age 65 is expected to grow by as much between 2010 and 2030 as it had in the prior 80 years. In tandem, these two phenomena portend a significant increase in the demand for health care in coming decades, and much of it is likely to be funded through publicly funded insurance programs aimed at the elderly.

Not only will the increase in the elderly population and their natural tendency to use more health care drive up the costs of Medicare in the future, but two additional factors are likely to further exacerbate these forces. The first is the excessive price inflation that seems to persist in the health sector of our economy. While medical price increases as reflected in the CPI in comparison to overall growth in the CPI have moderated recently, the ratio of the Medical CPI to the total CPI has been larger from the beginning of this decade through the end of 1996 than it has been over the prior three decades. It is premature to conclude that recent softening in medical price inflation will persist in the long term. The record from the last 40 years does not support that conclusion. The second factor that will drive up future health costs is the continued technological development and more intensive treatment of patients. Development of life-extending technologies account for the rapid increase in the numbers of elderly persons over 85 years of age in recent years. The numbers of baby boomers who will live to these ages could have a tremendous effect on health care consumption rates by 2030.

These four factors, the greater consumption of health care by older people, the aging of the population, the high inflation rates in this segment of the market, and cost expanding technologies are all compounding factors that will drive up the cost of Medicare claims even in the face of program reforms. Current projections suggest that under present law Medicare's claim on the economy will grow from 2.5 percent of GDP today to 7.5 percent by 2030. The underlying assumptions in that projection, however, assume that the added price inflationary pressures and the increased costs of treatment due to cost expanding technologies will largely be eliminated by the end of the first decade of the next century, just as the first of the baby boomers begin to turn age 65. In other words, our current Medicare projections assume we will have an amelioration in inflationary pressures on this program just as the baby boomers begin to bring on tremendous levels of new demand.

Yet another problem in dealing with the Medicare dilemma is that policymakers will find that they cannot get the same leverage from limiting eligibility that they can get with Social Security. If normal life expectancy at age 65 is 18 years, a two-year increase in the normal retirement age will reduce Social Security claims by roughly 2/18ths or 11 percent. In the case of Medicare, raising the age of eligibility would move some recipients to Medicare disability or Medicaid coverage, and these tend to be the high-cost cases. For others, it would extend VA or CHAMPUS coverage. Figure 5 shows the aggregate effects on case loads and potential cost reductions from raising eligibility ages under the program and does not include the extra potential costs to the government in its own retiree health benefits coverage.

The point of this lengthy discussion is that we cannot consider the rebalancing of the OASDI program in a vacuum. The potential rededication of 2 percent of GDP to rebalance OASDI might be tenable if that were the only imbalance that the government were facing. But it is not. There is also a tremendous imbalance in Medicare, a program targeted at exactly the same population. For the reasons outlined, Medicare's claim on the economy is going to be much harder to reduce or stabilize than Social Security's. We have to consider rebalancing Social Security in the larger context of the total federal government's claim on the economy and within the context of other entitlements that must be financed out of total government revenues. It does not make any difference that there is a separate earmarked tax that finances Social Security. There only seems to be so much the public is willing to give to the government and there are other things that government has to do with those limited resources besides financing entitlements.

FORCES DRIVING TOWARD CONSIDERATION OF NONTRADITIONAL POLICY OPTIONS

In the Advisory Council's deliberations, there was virtually no support for a straightforward increase in the payroll taxes when we discussed that approach to rebalancing the system. We spent a great deal of time developing an option that would have reduced benefits to live within current statutory tax rates. When we finished developing that option, there was virtually no support for it among the Council members. The unwillingness to raise taxes or cut benefits in a straightforward manner drove us all to consider policy options that have not previously been on the table. But we split into three camps in terms of the particular policy options that we ended up supporting.

The first camp, comprised of six Council members, advocated several changes, essentially maintaining the current level and structure of benefits. Thus, their proposal was called the Maintenance of Benefits (MB) proposal. They advocated: (1) increasing the number of years of earnings used in determining benefits from 35 to 38, moderately reducing benefits for workers who do not work more than 35 years; (2) diverting some income tax revenues now going to Medicare to the OASDI funds; (3) taxing all benefits above workers'; own lifetime nominal payroll tax contributions—i.e., their own basis in benefits; (4) investing 40 percent of the trust funds in the private equity markets to get a higher rate of return than that provided by current investments; and raising the payroll tax rate by 1.6 percentage points in 2045.

The MB option was opposed by the majority of the Council. Even among its advocates, most came to oppose certain of its elements, although they counted the expected revenues from the whole proposal. Those of us opposed to the MB plan were particularly concerned about the investment of OASDI assets in private capital and the increase in the tax rate in 2045. On changing investment policy, we are concerned that the equity accumulation would be so large that investment decisions would become politically motivated. We are concerned about irresolvable conflicts of interest as the government would try to reconcile its fiduciary obligations to program participants while also regulating companies in the investment portfolio in the interest of the public's health and welfare. In addition, we do not believe that the corporate governance issues can be resolved without government taking an active role in ownership direction of the assets it owns. On raising the payroll tax, we felt strongly that it would be unfair to impose taxes on our grandchildren that we are unwilling to pay ourselves.

The second group on the Council, comprised of two members, advocated that future benefits should be reduced to match the 12.4 percent of covered payroll now dedicated to financing OASDI, but that Social Security benefits should be supplemented by a defined contribution plan financed by employee contributions of 1.6 percent of covered payroll. This saving plan, known as the Individual Account (IA) plan, would work much like a national 401(k) plan administered by Social Security. Social Security would collect and manage contributions. Workers could designate the investment of their funds across restricted choices—e.g., a government bond fund, a corporate bond fund, and limited equity funds—but the government would manage the money. At retirement, workers would be required to annuitize the assets in their individual accounts. The combination of the scaled down Social Security benefit plus the IA benefits would roughly replicate current-law benefits.

The remaining five members of the Council, including me, were uncomfortable with the prospect of Social Security running this large investment scheme—indeed, managing more money than under the MB proposal. We felt it was important to prefund more of accruing benefits financed by the payroll tax than under current law, but thought it unwise to have the government so involved in the investment of the accumulated assets. We advocated significant reorganization of the current system. We proposed that the 2.4 percent of covered payroll that now finances disability and young survivor benefits should continue to be financed through Social Security as now. Under our proposal, the employers' portion of the remaining payroll tax, 5 percent of covered payroll, would finance a flat benefit payable to all long-career workers. The employees' remaining 5 percent would go into Personal Security Accounts (PSAs) that they would manage like they manage 401(k) or IRA assets.[2] The combination of the scaled down Social Security benefit plus the benefit funded

[2] For a complete description of this proposal and its financing and benefits implications, see Sylvester J. Schieber and John B. Shoven, "Social Security Reform Options and Their Implications for Future Retirees, Federal Fiscal Operations, and National Savings," a paper prepared for a public policy forum, "Tax Policy for the 21st Century," sponsored by the American Council for Capital Formation, Washington, DC, December 1996. Copies available from the author on request.

by the PSAs would generate higher benefits, on average, than now provided by current law.

CRITICISMS OF THE PSA PROPOSAL AND RESPONSES TO THEM

The PSA proposal has been criticized for several reasons but primarily for three important ones. First, critics argue that the creation of a two-tier system with a defined contribution benefit comprising the second tier would erode the public's support for the redistributive aspects of Social Security. Second they argue that the PSA proposal would expose workers to undue risks in the financial markets. Third, critics argue that the PSA proposal would create tremendous new federal debt obligations for future taxpayers that do not exist today. Each of these will be addressed in turn.

The combined tiers under the PSA proposal would continue to deliver redistributive benefits similar to the current system. According to the projections developed by the Social Security actuaries for the Advisory Council, the PSA proposal offers the potential for both low-wage and high-wage workers to become better off under a proposal of this sort than under the extremely low rates of return provided by the current system as a result of the funding of benefits that is an important element of the proposal. The essence of the argument that high-wage workers would oppose the first-tier of the PSA system is that they would get such a relatively low rate of return from the first tier compared to the second that they would campaign to have all their contributions go to their individual accounts. Since the PSA system would essentially have the same redistributive characteristics as current law, this opposition would only seem to arise because workers might understand the redistributive characteristics more clearly under the PSA than under current law. But it is likely that most workers already understand that the system is redistributive, either on their own or because many commentators and financial planners tell them about it. Furthermore, if the only way we can get the public to support such a program is to confuse them about how it works, the program is not established on a sustainable basis and will ultimately be challenged anyway. Finally, a number of other countries, including Canada and the UK have run their social security programs this way for years and those programs continue to receive widespread public support.

The second argument concerns the PSA or the IA plan exposing workers to investment risk. This argument often paints a picture of individual account plans creating risks for workers where none exists in the current environment. To illustrate that this is a distorted perspective, consider the hypothetical case of two brothers. The first held all of his retirement wealth in the form of Social Security promises at the beginning of 1977—i.e., he had no personal retirement savings or pension rights. He was not going to be eligible to retire until five years after the implementation of the 1997 Social Security Amendments—i.e., he was one of the notorious notch babies. The net effect of the 1977 Amendments was to significantly reduce his retirement wealth. His brother was somewhat younger and managed to hold all of his retirement wealth as financial assets invested in the stock market. The younger of the brothers happened to be hiking in the Himalayas through the month of October 1987 and came home to find that his retirement wealth had been significantly reduced by the stock market crash that month. In relative terms, the older of the two brothers suffered a greater loss in his retirement wealth than the younger. Today, Social Security is significantly underfunded. Either benefits are going to be cut or taxes raised to finance them. Either cutting benefits or raising taxes poses significant risk to program participants. The PSA proposal would diversify workers' risk between the financial markets and the political world in which Social Security financing decisions are made. Many policy analysts see such diversification as desirable.

The third argument is that the PSA would create tremendous new federal debt obligations for future taxpayers that do not exist today because of the transition costs that are part of the proposal. The reason that this argument is given any credence is because the government does not consistently account for its future obligations. The formal debt of the federal government is a promise to pay the holders of that debt the face value of the bonds they hold at a future point in time. Paying off those bonds will be a burden on future taxpayers. It is carried on the books of the government. Future entitlement obligations are created by statute and are promises to pay beneficiaries in accordance with those statutes in the future. Meeting future statutory obligations will be a burden on future taxpayers just as paying off formal debt will be. But statutory obligations are not carried on the books of the government. While legislators can reduce statutory benefits and the future tax burdens they portend, there is tremendous reluctance to do so.

Table 1 shows projected government obligations under the various proposals that were developed by the Social Security Advisory Council. The one that most significantly reduces the long-term governmental obligations of the taxpayers is the PSA plan. Considering the full projected cost of the transition, including the cost of transition borrowing, the PSA proposal reduces future taxpayer obligations nearly twice as much as the IA proposal. It reduces them by more than 20 times the MB proposal's reductions. It is the only proposal that would reduce the claim that OASDI payments by the government would make on the overall economy.

TABLE 1

PRESENT VALUE OF OASDI'S 75–YEAR OBLIGATIONS UNDER ALTERNATIVE POLICY OPTIONS (Dollar amount in billions)

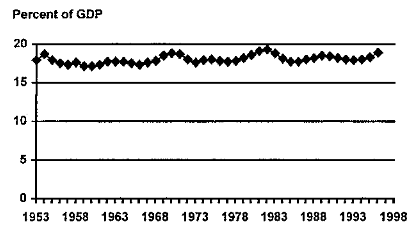
	Obligations	Change from current law	Percent Change
Present law	$21,345		
PSA flat benefit*	14,619	$ 6,726	31.5
PSA flat benefit plus transition tax*	16,487	4,858	22.8
OASDI benefit under IA proposal*	18,867	2,478	11.6
MB proposal	21,177	228	1.1

Source: Social Security Administration, Office of the Actuary.
* Balances do not include the individual account balances in either the PSA or the IA proposals.

While several members of our Social Security Advisory Council and others have branded the PSA proposal radical, I suggest that we look at the world around us to see that such proposals are becoming commonplace. Reforms of this sort are sweeping across Latin America. Similar reforms have been adopted in a number of countries in the Australasian sphere of the world. They have been implemented in the United Kingdom and are being considered across other countries of Europe. What is radical about the PSA proposal is that it would create an opportunity to turn our national retirement program into a system that would begin to fund its benefit promises by adding to the savings base of our economy. We believe it would also restore confidence in a system that the majority of taxpayers today believe will not deliver the benefits that are being politically promised.

Figure 1

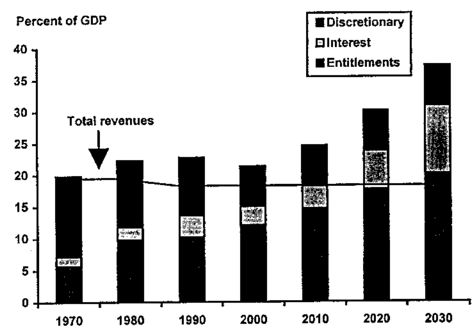
Three-Year Averages of Total Federal Receipts as a Percentage of GDP



Source: *Historical Tables: Budget of the United States Government, Fiscal Year 1998*, pp. 21-22.

Figure 2

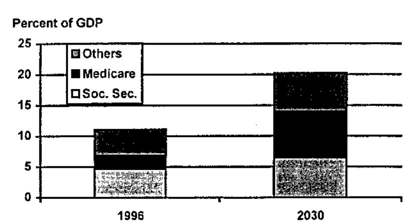
Federal Outlays and Revenues under Present Law[1]



Source: Bipartisan Commission on Entitlement and Tax Reform, *Interim Report to the President* (Washington, D.C.: U.S. Government Printing Office, 1994), p. 7.

Figure 3

Breakdown in Projected Claim by Social Security, Medicare, and Other Entitlement Programs as a Percentage of GDP

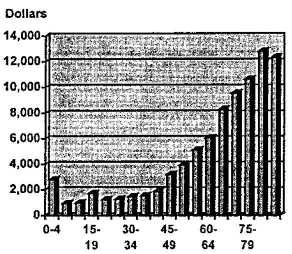


Sources: Bipartisan Commission on Entitlement and Tax Reform, *Interim Report to the President* (Washington, D.C.: U.S. Government Printing Office, 1994), p. 7 and National Health Accounts, Health Care Financing Administration; National Income and Product Accounts, U.S. Department of Commerce; and Social Security Trustees assumptions for the projection period.

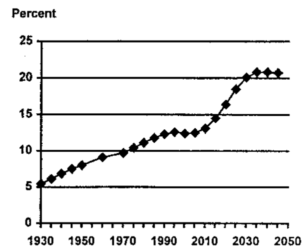
Figure 4

Average Per Capita Health Expenditures by Age Group in the United States and Portion of the Population Over Age 65 Historically and Projected into the Future

1995 Per Capita Health Expenditures



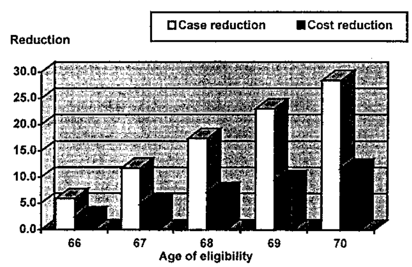
Percent of Population Over Age 65



Sources: Roland D. McDevitt and Sylvester J. Schieber, ***From Baby Boom to Elder Boom, Providing Health Care for an Aging Population*** (Washington, DC: Watson Wyatt Worldwide, 1996); US Bureau of the Census, ***Historical Statistics of the United States, Colonial Times to 1970, Bicentennial Edition, Part 1*** (Washington, DC, 1975), pp. 8-10; and ***1995 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds,*** p. 147.

Figure 5

Medicare's Aged Case Load and Cost Reductions with Alternative Eligibility Ages



Source: Watson Wyatt Worldwide's Health Policy Simulation Model as described in Roland D. McDevitt and Sylvester J. Schieber, ***From Baby Boom to Elder Boom, Providing Health Care for an Aging Population*** (Washington, DC: Watson Wyatt Worldwide, 1996).

Chairman BUNNING. I thank the panel for their testimony. I would imagine, through questioning, more details will be revealed. I want to start with Mr. Ball. Mr. Ball, your plan restores solvency only if it assumes that 40 percent of the trust funds are invested in the stock market. Yet you did not include this feature in your final plan, only offering it as a recommendation. What do you recommend to close the gap if this approach is not pursued?

Mr. BALL. If it is decided after consideration and study that the Administration and the Congress do not want to invest central Social Security funds in stocks, then there are several alternatives. We would be dealing with a remaining deficit of 0.80 percent of payroll. The first possibility I mentioned in my opening remarks, is that I think it is somewhat likely that there is going to be some redefinitions of the CPI which would mean a slowdown in the cost-of-living adjustment, COLA, and to some extent reduce that 0.80 percent. I am not advocating this. I just think it is likely to happen. Beyond that, I would propose that there be a modest increase in the maximum tax and earnings base of say $10,000. Counting the fact that those who pay more will get additional benefits, this change would reduce the deficit 0.20 percent of payroll.

Beyond that, I believe that probably the best thing to do would be a modest increase in the contribution rate. The other two plans in the council report have major increases in the payroll tax. The backers of the IA plan do not want to call it a tax, but it is a considerable increase in deductions from workers' earnings, which has many of the characteristics of a tax.

In our plan, we do not propose any significant increase for the next 50 years in the tax rate, even as an alternative, but under the circumstances that you propound, I would think perhaps a combined tax rate of about 0.40, that is 0.20 on each, starting in 1998, when most other changes would be scheduled to go into effect would reduce the balance another 0.38 percent of payroll and with modest CPI changes bring the system fully into balance without investment in the stock market. I think investment in the stock market is a very good idea, but I recognize that it is controversial enough that it might not get adopted. In any event, it is not the only way to bring about long-term balance.

You do not have to go to individual accounts. You do not have to change the whole system, as the PSA plan would do, in order to bring the system into balance. It can be done by quite traditional means if central investment in stocks is not accepted.

Chairman BUNNING. I just have one followup question. Regarding the recommendation to study the investing of 40 percent of the trust funds, did you determine how the stock market would be affected by such a large influx of dollars?

Mr. BALL. There was no detailed study of that. However, although the proposal would invest a large proportion of Social Security funds and even a large proportion of all government funds, it is not a large part of our $7.5 trillion economy. The amount that would be going into the stock market probably would not exceed about 5 percent of the value of the stock market and the total would be reached gradually over the next 15 years and from then on new investment in stocks would be a declining portion of the value of all stocks. It does not appear that it would have any very significant effect. I am not personally really expert on the performance of the stock market, if anybody is, but——

Chairman BUNNING. We found out Dr. Greenspan is. [Laughter.]

Mr. BALL [continuing]. Dr. Greenspan certainly has more credentials than I do in that area, but we have a member of our group who you may want to consult with at sometime in the course of these hearings Thomas Jones, who is the president of the Teachers Insurance Annuity Association-College Retirement Equity Fund, TIAA–CREF, which is the largest private pension and group insurance plan in the country, is very experienced in this matter. That is what he does everyday.

Chairman BUNNING. I have a question for Dr. Gramlich. If FERS, the Federal Employment Retirement System, is your model for an individual account, what would prevent the Government from attempting to influence the operation of any company's assets that they might own?

Mr. GRAMLICH. Well, there would be several checks. First, the individuals would be given a choice of five to ten funds, and so no one fund would have a monopoly, and no one fund would be that large. My funds would be significantly smaller than the amount of stock market investment envisioned under the study part of the maintain benefits plan. And second, I have not heard any reports that the Federal thrift plan is abused in any way. In fact, you barely read about it, and so I think that setting up accounts—these would be nonbudget accounts, be alongside the budget—and I think setting it up in that way it would be like standard 401(k) plans, and I do not see any likelihood that that would be at all abused.

Chairman BUNNING. Well, under our 401(k) plans, the investments are not in individual stocks, they are in averages like the Standard & Poor's 500.

Mr. GRAMLICH. That is right. Yes.

Chairman BUNNING. And, therefore, we do not own the stocks as such, but we own the average, and therefore we would not be able to control any of the amounts.

Mr. GRAMLICH. That is right. And the individual accounts work the same way. These would be average funds, index funds.

Chairman BUNNING. You would buy the average in other words?

Mr. GRAMLICH. Buy the average.

Chairman BUNNING. Instead of buying General Motors?

Mr. GRAMLICH. That is right.

Chairman BUNNING. Or Ford?

Mr. GRAMLICH. That is right.

Chairman BUNNING. Or Chrysler?

Mr. GRAMLICH. That is right.

Chairman BUNNING. Or something like that?

Mr. GRAMLICH. That is right.

Chairman BUNNING. Question for Dr. Schieber. In your testimony you emphasized the importance of balancing Social Security in the larger content of Federal fiscal operation, making a number of compelling arguments. Would you please summarize your views in this area for us?

Mr. SCHIEBER. Well, first of all, if you go back and look at the work that the Entitlement Commission did a couple of years ago, it suggested that the amount of revenues that the Government has been willing or able to collect from the taxpayers over the last 40–45 years has been relatively constant between 17.5 and 19 percent of gross domestic product, and they said if that is the amount that we can collect, then what are the issues that we are going to be facing as the population ages and we kind of naturally mature our entitlement programs? And they concluded that by 2030 that the entitlement programs related to the elderly themselves would claim the full allocation that taxpayers have been giving to the Federal Government historically.

And so they said that something has to give. And when you look at Social Security in the context of the entitlement programs, Social Security and Medicare make up about three-fourths of them today. The largest growth in these in the projected future is going to come in the medical area. One of the problems that we have in dealing with the medical area is that there are a number of factors that are going to make reductions there more intractable than in the cash benefit programs. Older people use more health care than younger people, and we are an aging society. We are aging at the very oldest ages more rapidly than anywhere else.

We do not have the same kind of leverage that we do with Medicare in terms of increasing the entitlement age. If we raise the eligibility age in Social Security, say 2 years, and life expectancy is 18 years at age 65, you reduce the total benefits that you pay to a single person by 2/18ths, about 11 percent. In Medicare it does not work that way. Older people use more health care than younger people, and even the sickest of the younger elderly would probably still end up getting disability benefits. So it is going to be very hard to constrain that. Social Security, as it is currently configured, is expected to expand its claim on GDP, our total output, from around 4.8 percent today to about 6.8 percent by 2030.

So if you have got these other entitlements growing, and we have got this kind of overall limit, we are going to have to constrain something somewhere, and we tried to come up with a proposal in this larger context that would do that, that would give people financial assets so they would have other claims outside the Government to meet their retirement needs, and I think that drove our thinking very strongly.

Chairman BUNNING. I want to ask all of you one question. If you were a benevolent dictator, as was the case when they changed the retirement system in one Latin American country, at what point in time do you think that we can act prudently? What year? 2000? 2010? Or somewhere between 1997 and 2012 when we start dipping into the trust funds. When should we take some action to ensure Social Security remains solvent for the next 75 years? I would ask all three of you.

Mr. SCHIEBER. I would be happy to start with that. The former Chairman of this Subcommittee, Congressman Pickle, put in a proposal shortly before he retired that would have reduced benefits as the way to fix it. The benefit reductions that we would be facing if we were going to make them today would be around 20 to 25 percent of current promised benefits. If you were to make a benefit reduction say of 25 percent to fix the program, and you were to implement it with a 10-year lead time so it would affect, say, people that were 55 years of age and younger, for a person who was 55 years old, if they wanted to save on their own to make up for that benefit reduction, would have to save about 10 percent of their earnings each of their last 10 years that they worked.

If you could give that worker a 20-year lead, it would be about 4.5 percent. If you could give the worker a 30-year lead, it would be a little under 3 percent. The longer lead time you can give people in terms of forming their expectations for what they are going to get from this program so they can develop the rest of their retirement program on a rational basis, the fairer you are going to be with the American people. So I think the window is fairly short. I think the sooner you can go through the deliberative process, and you should definitely go through a deliberative process, you should not rush to judgment, but I think you should make a judgment and you should move with due dispatch because I think otherwise you are putting people, your constituents, in tremendous jeopardy.

Mr. GRAMLICH. I think we are all going to give the same answer to this question.

Chairman BUNNING. OK.

Mr. GRAMLICH. One date that could be kept in mind is that the baby boomers first become eligible for Social Security early benefits, in the year 2008. As Dr. Schieber said, you do have to give people advance warning in advance of that. So really I think the best time to make changes is in this Congress far and away.

Chairman BUNNING. Mr. Ball.

Mr. BALL. As I suggested earlier, I would move as promptly as you possibly could, meaning in this Congress, for solutions to about two-thirds of the problem. I am not saying that it is easy to do all the traditional things we propose—to extend coverage to the remaining State and local employees for example. Some States are going to object to that. Some employees are going to object. It is not easy to tax more of the Social Security benefit, which is part of this traditional solution. That was an issue in the 1994 election for example.

But these proposals are fair. It is actually desirable from an equity standpoint because that is the way other pensions that are defined benefit plans and contributory are taxed. Why should not Social Security benefits be taxed the same way? If you are going to change the COLA to a more accurate measure, if that is what happens, you would want to do it as soon as possible. Now in things like that—and we have a the list of five points—there is no reason to delay. They are understood. They have been talked about for a long time. Where a delay is justified—and I do not mean a long delay but where at least 2 or 3 years of discussion is justified—are these new ideas. Certainly if consideration is going to be given to individual accounts, that is a brand new blockbuster of an idea for Social Security. I am opposed to it, but it certainly should not move from anybody's point of view without a lot of consideration.

And I think that there is enough difference between the tradition in Social Security and investing some of the central fund in the stock market—even though it is indexed and even though it is passively managed—that I would not urge it right away. But I would not think you would need more than say 3 years to evaluate that kind of an approach. So we are all in agreement on very early action. I guess I am the only one that divides it into two parts and urges you to act very quickly on the traditional changes that have already been studied.

Chairman BUNNING. Thank you. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman. In my readings about your plans and the various comments that have been in many of the periodicals and newspapers, there seems to be a suggestion that by taking funds out of the Social Security trust funds and putting them into individual accounts or personal security accounts, you increase national savings, and, Mr. Gramlich, I heard you say that you had to have national savings. I am sure Mr. Schieber agrees. Could you further elaborate how, in fact, your plans with these new ideas do increase national savings because we cannot do it unless we increase national savings.

Mr. GRAMLICH. Yes. Well, let me start on this. My individual accounts would be on top of Social Security, and you can probably divide the world out there into those workers who have defined contribution pension accounts on top of Social Security and those who do not. Roughly half of the work force do not have any pension saving on top of Social Security, and so if you mandate some saving on top of Social Security, then surely saving has to go up for that part of the work force.

Those who already have pensions on top of Social Security may to some degree reduce their pensions or have their employers reduce them. That does not bother me so much because they already have pension saving on top of Social Security. I am interested both in increasing national saving and in having it to some degree targeted to the people who are now not saving on top of Social Security, and I think my approach does that.

Mr. SCHIEBER. In the case of the personal security account plan, over a fairly lengthy period of time, we would be moving from a system that is currently almost totally unfunded. Today we have a little over a half trillion dollars in the trust funds, and that seems like a lot of money, but if we were to shut off the flow of revenues to the system, it would only last for about 18 months. So it is not very significantly funded. By the end of this fairly lengthy transition, more than half of the benefits in our system would be funded. The way we accomplish it in the short term is through a transition tax, and we are quite explicit about that. We called it a tax. We could reconfigure it so it would not be called a tax, but when you legislate that somebody should put some extra money in the bucket, we said let us be honest, let us not kid around, let us call it tax.

So we called it a tax. It is through that mechanism early on that you create additional saving. Over time, though, the system would become very significantly funded. By the end of the transition, more than 50 percent of all benefits would have financial assets laying behind them.

Mrs. KENNELLY. Thank you, doctor.

Mr. Ball.

Mr. BALL. Mrs. Kennelly, I am very glad you asked this question because I think there has been confusion about our plan and the savings issue. The maintain benefit plan over time, if you take say the year 2030, has savings that are the equivalent of about two-thirds of the savings that are claimed without any offsets for the IA plan. It is about half of what is claimed for the PSA plan but without any offsets, and, as Dr. Gramlich said, there is very good reason to think there would be some offsets. So on the savings effects, these plans are closer together than that seems.

But all savings that we need in the economy do not have to come from this change in Social Security. It is very important to do, and it is good to have Social Security changes make a contribution, but it is not the whole story. I am concerned about this proposal to deduct another 1.6 percent from workers' earnings for the sole purpose of retirement. Professor Gramlich is saying that he wants to focus on the people who are not now saving. The problem with that is I do not think you are doing relatively low-income workers any favors to make them save more, particularly for the single purpose of retirement. Many of those workers live payday to payday. Many of them need all their income for food, clothing, and shelter. Almost all need income for partial protection, at least, and maybe total protection against the cost of health care.

You really make it harder to solve the Medicare problem, which is a much more difficult problem than the Social Security problem, if you preempt deductions from workers' earnings or payroll taxes for this one purpose of retirement. So as good as savings are, not every way of accomplishing savings is desirable. These other two plans get their savings almost entirely on the basis of increased taxes. We can do the same. You can add an increased tax to the maintain benefit plan and it results in savings the same way.

Mrs. KENNELLY. You have got the other gentleman's attention, Mr. Ball.

Mr. GRAMLICH. Yes, he did indeed get my attention. If I could come back on that, I said in my testimony, and I will repeat here, that my plan was the only one of the three plans that did not worsen the finances of the Health Insurance Trust Fund. I mean that seriously. Both of the other plans have an implicit tax increase that they are not telling you about, in that, the Health Insurance Trust Fund is on pretty shaky grounds, as you know, and they are diverting revenue one way or another from that Health Insurance Trust Fund so they are going to have to make it up in taxes, and so there are a lot of things that are going up and down in these plans.

But I do think that my esteemed colleague, Mr. Ball, has misstated the issue on health insurance because it is his plan that is actually diverting revenues from the Health Insurance Trust Fund, not mine.

Mrs. KENNELLY. And that is where you take the funds that are taxed from Social Security and take them out of the Medicare Trust Fund and put them back? That is what you are talking about?

Mr. BALL. Yes, Mrs. Kennelly.

Mrs. KENNELLY. And that is a concern of mine.

Mr. BALL. Let me tell you what the proposal is. The proposal is really to correct an anomaly that crept into the system, not by the rules of the House but by the rules of the Senate. In the 1993 amendments, when taxation of Social Security benefits was extended—under they call it the Byrd rule in the Senate—you could not put that extra tax money, in OASDI. The Senate was barred from adding income to OASDI or taking away from OASDI except by a supermajority of 60 votes. So they parked the income in the Medicare Program, taxes on Social Security benefits in the Medicare Program.

We are not proposing that it be taken away now. We are proposing only that when Medicare is refinanced, as it must be, between the years 2010 and 2020, that it would be desirable, since the financing is being changed anyway to take into account that Medicare is now getting money that really should be in the OASDI system. At that time I would transfer future payments to OASDI where they belong.

Mrs. KENNELLY. I am going to end this debate because I just have time for a few more questions, but I do want to say my memory, and I voted on that, was, in fact, that every few years because of the trustees' report, we have to do something to keep Medicare solvent.

Chairman BUNNING. Yes.

Mrs. KENNELLY. And one of the ways we did it was to take those dollars and put them in the Medicare Trust Fund, and every time I have a townhall meeting, to this I get brought to task for having done it. I can say honestly I did it to keep the Medicare Trust Fund solvent, and I think it is 14 percent of the change. If we took that money back to the Social Security system, it would be 14 percent of the changes needed to achieve solvency. So I do not know, Mr. Ball, if you are going to get it back, but I think we would have to think about it long and hard. But before I finish because all these gentlemen are waiting to ask questions, I am concerned about the situation of widows and divorcees in these plans.

Social Security was there for widows and children, and I understand the huge amounts of women now working. However, when I look at the plans, and particularly when I look at the flat benefit that Mr. Schieber gives, I figure that a divorcee might end up with $205 a month under your plan, and that certainly disturbs me. I am also worried that some years ago we passed legislation, and in the legislation we made it mandatory that before a man could take it just for himself, he had to have his wife's consent. We do not see any of that there. I wish you would address that. In fact, women work a shorter amount of time, coming in and out of the workforce to have children, and end up with lower benefits. How, do you protect women in these new plans from, in fact, having a very, very small benefit?

Mr. SCHIEBER. Well, first of all, if you look at the labor force participation rates of women today and compare them to the labor force participation rates of retired women today, they are very significantly different. For the most part, if you look at the retired women today and you consider their daughters at similar points in their age spectrum, the women today's labor force participation rates tend to be about 35 percent higher, 30 to 35 percent higher than the mothers' labor force participation rates were when they were a similar age.

So the spousal benefit that was implemented in the 1939 amendments and has been provided by Social Security throughout the years was a very different benefit when it was initially implemented than it is today. Now, to the extent that women are working, women would accumulate their own entitlement rights, and in many regards our plan is more fair than the current plan.

Mrs. KENNELLY. Then would they then get their own account?

Mr. SCHIEBER. They would get their own benefit. Now if equal sharing of earnings during a period that people are married, if that is a concern of yours, it would actually be more easily achievable under our plan than it is under current law because if you wanted to actually split in any year a couple were married, if you wanted to split their total earnings, their total contributions to their combined PSAs, you could split it at the end of each year, and you could say that this was something that was not subject to negotiation at divorce. If earning sharing is a true concern, there would be a legislative way to deal with that that I think would be much easier than what you've got today. So we are not totally oblivious to the needs of women.

Mrs. KENNELLY. And I also want to put on the record that I don't know where you got the fact that all of a sudden instead of a wife having 50 percent of the benefit, she only needs 35 percent of the benefit. I am concerned. I am glad I asked some of these questions because when we began this hearing, everything was sweetness and light, and I think this has brought out that there is going to be some serious debate, and so we are going to have to sharpen the pencils pretty well before we get to the point where we can agree on a lot because there is a lot in this. Thank you, Mr. Chairman.

Chairman BUNNING. Mr. Johnson will inquire.

Mr. JOHNSON. Thank you, Mr. Chairman. Mr. Ball, you mentioned in your testimony that you were trying to protect Social Security and use traditional methods, and you used that word several times. I wonder if you pursued all the avenues that were available and, one, why you did not want to raise the retirement age in your idea?

Mr. BALL. When I replied to the question about what would we do if it was not possible to invest in the stock market, if people ruled that out, I should have added that one possibility would be to reduce benefits by the device of raising the age at which people get full benefits beyond the 67 that is in present law. I would do that with great—I would agree to that with great reluctance. I think the problem is that it is another way of cutting benefits, but the incidence of cutting benefits falls on the people who have the hardest time staying in the work force. That is people who are dependent upon their own hand labor. It is people who are handicapped but not to the degree where they can get a total disability benefit. The proposal runs, too, against what has been happening. I would favor raising the retirement age on a demonstration that people were actually working longer, and that private industry was giving them jobs, and that private pensions were also raising the age of normal retirement.

Going to age 67 has been in the Social Security law now for 14 years. We are going to gradually start, beginning in 2000, raising age 65 to 67. But there has been no response to try to deal with this fact. Quite the contrary. The age at which people actually are retiring continues to go down, and here we already have a policy in Social Security which says, well, we are going to go in the opposite direction. I think Social Security policy and actual retirement ought to go together. We have a natural experiment here. We have 67 in the present law. Let us try it. Let us see what happens under present law, and if it works well, if there really are jobs there for older people, surely, later on we can go to 68. You do not have to do it now.

Mr. JOHNSON. OK. You know you talk about putting Social Security back in the form, I guess, that it originally was in. That was one of your reasons for taking Medicare contributions back from where they were, but were not disability payments also not part of Social Security originally, and did you propose to take them back as well?

Mr. BALL. Mr. Johnson, if I gave the impression that I want to take Social Security back to the way it used to be, that was a wrong impression. I did not mean to give that impression.

Mr. JOHNSON. OK. Well, that is kind of the impression I got. I am sorry.

Mr. BALL. I think Social Security has been greatly improved and properly so. It pays higher benefits. It pays total disability benefits. It protects against increases in the cost of living. It has done much better by women than it used to. I think it is a greatly improved system, and we need to maintain it with all its improvements.

Mr. JOHNSON. Yes. For all of you, do you think you really considered all the options? I know you discussed it at length among yourselves in your various groups and came up with these proposals, but do you feel like you overlooked any solution, or do you think there was maybe something that you all failed to talk about that has come up since? Whoever wants to go first.

Mr. GRAMLICH. We spent 2½ years on this and there has been a huge amount of debate. I personally have not seen any idea since we made our report that I was not aware of before we made the report.

Mr. SCHIEBER. Right. Or that we discussed. We kicked most of the rocks.

Mr. JOHNSON. Did you? And you did not find any snakes?

Mr. SCHIEBER. We broke our toe a time or two. There were snakes.

Mr. BALL. I think, Mr. Johnson, this does give me an opportunity, though, to say that even though we may have considered all individual proposals, I do not think we came up with the three best plans. I think the two plans that set up individual accounts have so many disadvantages to them, I would not consider them a second, third, or fourth choice. Our group of six people are completely opposed to the idea of reducing the basic central Social Security system and then trying to make up for the reductions with individual accounts which may come out the same on average but only on average. Many will lose.

Mr. SCHIEBER. But the majority did support individual accounts, and the fact of the matter was in the final analysis the group of six who are dedicated to the current system could not even agree on their proposal.

Mr. JOHNSON. Thank you, Dr. Schieber. Thank you, all.

Chairman BUNNING. Thank you. Mr. Collins, we will give you 5 minutes, and then we will recess and go vote.

Mr. COLLINS. I will yield my 5 minutes.

Chairman BUNNING. You will yield. Mr. Jefferson.

Mr. JEFFERSON. As I think about these three reports, I want to ask you this. When you started out this work at some point, as you were undertaking it, did you agree on the goals that you were seeking to attain as a result of your work? Was there agreement on just fundamental goals that you were seeking to accomplish?

Mr. GRAMLICH. I will speak for myself. I think there is broad agreement on the fundamental goals. I think that all of the plans attempt to provide a social safety net of some sort. It is different in the different plans, but there is broad agreement that that is a goal. We certainly agreed that we should make the system financially sound over the very long run, and by very long run, we mean very long run, and so there was certainly agreement on that. There was less agreement on the goal of raising overall national saving for retirement. There was some disagreement on how important it is to do that within the context of Social Security, and so there might be some disagreement there, but I think that there was broad agreement on goals, speaking for myself.

Mr. SCHIEBER. And I agree.

Mr. BALL. I find that generalization hard to agree to. It seems to me these individual accounts have in mind other goals than the traditional Social Security ones. They are perfectly legitimate goals for people to have, but they are different. One new goal is individual control over part of the individual's own savings. That is a new goal within Social Security as against——

Mr. JEFFERSON. Everybody agrees, though, on this idea of solvency of the system. I mean that is obviously what—but the emphasis on security plays in different places. Mr. Ball, in your proposal, the security interest looks like security with respect to the benefits, and in the other plans, the benefits get dealt with tampered with, reduced, and the emphasis is on the security of having a safety net, something there to fall back on but not necessarily security of the standard benefits. And I guess as we go through this, we have got to figure in which of these directions really we are going to go. Let me ask you about the—Dr. Schieber, I believe—let me see if I can understand this. It is correct to say that between 1998 and 2029 that the Federal spending under the PSA plan would rise by over $7 trillion? Is that correct?

Mr. SCHIEBER. I find it unlikely, but I cannot respond to that precisely.

Mr. JEFFERSON. What is your figure? Do you have one?

Mr. SCHIEBER. The present value of the transition cost is in the table, Table 1. It is stated in total dollars—I do not even have a copy of my own full testimony with me—you show the cost of benefits that are provided under OASDI through the PSA plan relative to current law, and then there is a second line in there that includes the present value of the full 75-year transition cost. It reduces the cost to the taxpayers over the lifetime of the program.

Mr. JEFFERSON. What it seems to show here is that there is going to be an increase in the national debt if your program is adopted as it is presently presented?

Mr. SCHIEBER. We were very explicit. We laid that out in detail in the report. In present value terms, the amount of the added debt, formal debt, would accumulate to I think it is around $1.2 trillion. In 1996 dollars, it would accumulate around 2030 to about $2.4 trillion.

Mr. JEFFERSON. Well, if we do this, are we not going to erode any idea of increased national savings when we increase the debt that people have to pay to fund it?

Mr. SCHIEBER. The amount of saving that goes on in the PSAs themselves is significantly more than the added temporary Federal debt, and that temporary Federal debt is ultimately paid off by the explicit transition tax that we included in the proposal. In net over time, we reduced the cost to the taxpayer of the overall system significantly.

Chairman BUNNING. We are going to have to recess, if you will be patient again.

Mr. SCHIEBER. Absolutely.

Chairman BUNNING. We will come back.

Mr. SCHIEBER. An important issue.

[Recess.]

Chairman BUNNING. The Subcommittee will come to order, and Mr. Neal will be questioning.

Mr. NEAL. Dr. Schieber, let me pick up on a question that Mrs. Kennelly asked before when we were talking about the safety net. If the debate is to lose its focus on Social Security being a safety net initiative, how can we conceivably take the risk of that widow who is living on the $7,000 or $8,000 a year by tying some of the moneys into the stock market? We do forget there are people out there who live solely on Social Security.

Mr. SCHIEBER. Well, if you look at a pay-as-you-go Social Security system of the sort that we have, the rates of return that people can get on their contributions over their lifetime when you have got a stable population is essentially the rate of growth in wages. Rate of growth in wages in our economy over the last 15 years has been something less than 1 percent real per year, 1 percent over inflation. The projections going forward we are expecting that it would only be around 1 percent. If you begin to fund some benefits, and this is one of the reasons why many of us think that we ought to try and figure out how to fund some of the benefits, you get a higher rate of return on the assets that you put away, and this is something that actuaries have learned and economists for years and years, that a funded pension plan, a funded retirement program, can throw off a higher level of benefits at a given cost than a system that is not funded.

And one of the things that we believe that would happen is that if you began to fund some of these benefits is that people over time would actually earn higher benefit levels than they do under current law, and the flat benefit in combination with the individual savings we think would have a more beneficial effect on lower wage workers than it would on higher wage workers, and this is all spelled out in the report.

So part of the goal here is trying to figure out how to fund these benefits, and as we began to make the commitment to fund, a number of us were very concerned about funding them in the fashion that the maintenance of benefits proposal suggested because the Government would become the largest single stockholder in the U.S., become the largest holder of equity capital, and we thought that would raise a number of problems. It would raise problems of potential political decisionmaking in terms of making investments. It would raise conflict of interest questions. The Government would have fiduciary responsibilities on the one hand. It would have regulatory responsibilities on the other, and in some cases those would conflict.

There are governance issues that are raised, and so we came to the conclusion that if you were going to try and fund a significant portion of benefit to get the economic benefits that derive from that, that you would be driven toward individual accounts. Now, five out of seven of us oppose the approach that Dr. Gramlich has proposed because the Government would be a larger manager of investment assets under that proposal than under the maintenance of benefits proposal, and so we were driven more purely to individual accounts.

So I think it is the funding that really drove us in the direction we went, and the goal was to provide larger benefits, not lesser benefits. Now there are risk issues, but there are risk issues all around, and I think we have to try and figure out how to continue to put the netting in the safety net, but we need to do it in a viable way where we can accomplish what we are trying to accomplish, and some of us do not believe that the current system can do that.

Mr. NEAL. Mr. Ball, you said something I thought was very interesting as it relates to low-income people and how to raise their rate of savings. You took a contrary position. You did not think that that was important to increase or encourage perhaps the working poor and others to increase their savings. Let me just build upon that for a second. I think that one of the things that is lost in this abstract argument over the CPI is that when you cut back 1 percent for the working poor or for senior widows, it is a pretty significant piece of change for them.

Mr. BALL. Yes.

Mr. NEAL. But I was curious about your position on savings for low-income Americans.

Mr. BALL. Mr. Neal, I certainly agree that it is very important to increase the U.S. savings rate, but I do not think you are doing low-paid workers any favors by forcing them to save more, particularly for the one purpose of retirement. Health insurance is one of the biggest needs of middle and lower income families, and to take 1.6 percent, as the IA plan does, in further deduction from wages entirely for retirement benefits seems to me, a mistake. If we are going to increase savings, which I think we should, I would not pick out low-income people to do the saving.

Now, if I might enlarge on that just a bit, I would like to say something about "averages" in all this discussion we have been having. Professor Gramlich in presenting his plan made the point that when you combined the basic Social Security system, as he would modify it, plus what workers get from the individual accounts, the two together on average would be roughly the same as what people get under the present system or what they would get under the maintenance of benefit plan.

That is true, but averages are a real problem if we are talking about the basic system. There will be a lot of people, by definition, who will be below average. So I have concern about the adequacy of the IA plan from the standpoint of their stated objective.

I would also like to criticize my friend's use of "adjectives" a little bit. He speaks of the kinds of cuts he would have in his plan as "mild," "as relatively small, particularly for low-income workers." But the truth is when you put together not just change in the benefit formulas, but everything he does to benefits, the average benefit is reduced 30 percent, and even the benefit for low-wage earners is reduced 22 percent. That does not seem small to me.

Mr. NEAL. I think Mr. Gramlich would like to comment that alright, Mr. Chairman?

Chairman BUNNING. You will get another turn, Mr. Neal.

Mr. NEAL. OK.

Chairman BUNNING. Mr. Hulshof will inquire.

Mr. HULSHOF. Thank you, Mr. Chairman. Good afternoon, gentlemen. Just a couple of quick background comments. I am obviously a newly elected member. I also ran in 1994, and coming through this past campaign season was just a lot different because of the misinformation about certain issues and trying to defend and talk about and educate on those issues. I appreciate the Chairman convening these hearings. As we begin this dialog, I quite frankly think that we should go outside these doors and continue to have this public discourse because I think we need to bring the American people in and allow them to weigh in on the various options that you have been talking about.

Now, I understand that the council actually convened a couple of technical panels to support you in your efforts, and I think one was on assumptions and methods. Is that right?

Mr. SCHIEBER. Correct.

Mr. HULSHOF. It is my understanding also that one of the conclusions was that the intermediate projections of the Social Security trustees provided, a reasonable evaluation of the financial status, and Dr. Gramlich, you are nodding in assent, and I would assume if there was any objection that you would tell me. I think part of the problem is it is very confusing when we bring the public in to begin to discuss these issues because there are so many things. You can pick up a newspaper everyday, and you have different estimates when Social Security will go bust. Some say, as early as, shortly after the year 2000. Some say it is at 2050, and there is this wide disparity and misinformation or perhaps correct information, but it is just not being communicated effectively. Can you give us any guidance as we begin this public discourse across the country as to how we can better present these proposals?

Mr. SCHIEBER. Well, it is difficult because all of the estimates for Social Security hinge on 75-year forecasts, and these are forecasts of the real wage growth, of fertility rates, of mortality rates for 75 years ahead. If you want to put it in context, it is as if we were sitting here in the Harding administration forecasting now and look at all that has happened since then that could not reasonably have been forecasted.

So the fact that in making 75-year forecasts, the numbers differ does not mean that anybody is giving misinformation or anything like that. It just means that there is real live uncertainty in these forecasts. The best guess of when the combined retirement and disability trust fund exhausts its assets—it does not mean it disappears, but it exhausts its assets—is 2030. That is the best guess. Then there is a range of uncertainty around that, and so I do not actually know what the precise numbers are. The most optimistic for the trust fund is that it would never exhaust its asset, and the least optimistic is that it would exhaust its assets somewhat before 2030. That is not misinformation. That is true information about the likely uncertainty we are likely to have with Social Security.

Mr. HULSHOF. Let me give a quick background for this question. Colleagues on the other side of the aisle, the blue dogs, have put together a coalition budget, and there has been some discussion by the press and even here in the halls of Congress, beginning to discuss the merits of various budget proposals. It is my understanding, if you know the answer to this, regarding COLAs, cost-of-living adjustments, that the coalition budget being offered by the blue dog coalition has a fixed COLA, and there is also some discussion about changing the consumer price index, the CPI. Did that come into your deliberations as well? Would any of you like to take that question, please?

Mr. GRAMLICH. Yes. We talked about that quite extensively. One is a political point that I believe we all agree on that if you put the inflation adjustment of Social Security in the domain of politics there are serious dangers. I think the wording in our report was that we would like to follow the Bureau of Labor Statistics, BLS, which does the consumer price index. We would like to follow that wherever it goes. There are grounds for thinking that the consumer price index is biased on the upward side, and there are things that BLS can do to change their procedures to go to a more current estimate of consumer market baskets and things like that would lower the rate of inflation, and we would all favor that.

But I will speak for myself at this point. I have serious misgivings about a separate Commission that is independent of the BLS and rules on how much the inflation adjustment would be. Let me make one other point about this whole thing, and that is that a key variable in forecasting the long-run finances of Social Security is the rate of real wage growth. That is wages deducting inflation. And if there is adjustment in the inflation indexation, whatever sort, in effect, what is being assumed is that there is going to be higher real wage growth for the whole 75 year period. It struck a lot of us on the Council that that would be a very risky assumption to make, that real wage growth has been down for a long time now, and a lot of that does not hinge on the measurement of inflation by the BLS, and so I think that there may be some way that there could be a downward adjustment in inflation. But I think this notion of a separate commission is very dangerous, and I would much rather have it come from the BLS.

Chairman BUNNING. The gentleman's time has expired. I have a question for Dr. Gramlich and Mr. Ball. Your plans call for taxing Social Security benefits the same way private pensions are taxed.

Mr. GRAMLICH. Defined benefit pensions.

Chairman BUNNING. Example. As they receive over what they have paid in.

Mr. GRAMLICH. Right.

Chairman BUNNING. Is this feasible in the Social Security program where someone can receive benefits on his own record as a retired or disabled worker but could also be eligible for benefits as a survivor or dependent on another's account? Did you ask SSA if they could do this type of bookkeeping?

Mr. BALL. It used to be thought that Social Security back 10–15 years ago was not in a position to carry out these individual calculations. I do not believe that is any longer the case. I think they indicated a year or two ago that they now could do it leaving aside the question of whether they thought it was desirable.

Chairman BUNNING. Did you ask them if they could do it in your deliberations?

Mr. BALL. Not as a formal request, I do not think; did we?

Mr. GRAMLICH. Not that I recall either.

Chairman BUNNING. In other words, you did not ask them if they could?

Mr. GRAMLICH. What I can say is this, that the Social Security Administration has reviewed the draft of the report that says they can do it many, many times, and it was sent all around the agency, and the only rewording that I remember in that process is that there are some people in the agency who feel that they could have done it before. We in the end changed the wording on that, but nobody questioned that they could do it now in the drafts they saw.

Chairman BUNNING. Dr. Schieber, you have something to add?

Mr. SCHIEBER. Could I make an informational point in regard to this observation?

Chairman BUNNING. Certainly.

Mr. SCHIEBER. The tax treatment of private pensions, I think, is different than it is really being characterized here in practical terms. To the extent that an employee contributes to a defined benefit plan in the private sector, the contributions are made with post-tax dollars, dollars that have already been taxed. To the extent that there is a benefit that accrues based on that, the benefit only becomes taxable in excess of the employee's base. The overwhelming majority—I mean it is virtually all private sector plans—because of this tax treatment of employee contributions, when employer contributions are tax deductible, virtually all of the contributions—there are some limited contributions that go into the plan, but very limited—are made by the employer because they are tax deductible.

The benefits that are distributed in the final analysis are then taxable. For defined contribution plans since the creation of 401(k)s for the private sector, both employer and employee contributions are made after tax. The tax treatment of private sector pensions, for all practical purposes, is extremely different than what is being characterized here.

Chairman BUNNING. Clearly, there are major disagreements among the three of you within the Council and among others in the Council. You are able to agree on four major areas of concern: Long-term balance, long-term balance beyond the 75-year horizon, contribution/benefit ratios, and public confidence. Can you tell me how you reached this consensus and how this consensus framed your deliberations? Any and all.

Mr. BALL. Mr. Chairman, I think on those things that you mentioned, we brought to the council views that were similar or the same.

Chairman BUNNING. Starting out?

Mr. BALL. Yes. It is not that they emerged from a negotiation or anything of that kind. And that is true of some other points, in the very first chapter. We also came to the conclusion that it was undesirable to test people's other income and then have a means test deducting such income from your Social Security benefit. We came to the Council individually agreeing on some of these things before we started the discussion, but it seemed good to record it.

Chairman BUNNING. Does anybody want to add anything?

Mr. GRAMLICH. The question of when we magically agreed, whether we came to it beforehand or agreed in the deliberations.

I do think that on the question of truly long-term balance, that was one where the discussion that the Council had did influence people, and they agreed to things that they might not have beforehand. So I think there was some value in our discussions, if you will.

Chairman BUNNING. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman. Just a quick question to Mr. Gramlich. My understanding is with your accounts that you suggest that you have them annuitized, and from reading your report I could not decide if it was a private annuity or a public annuity. The president's report says public. Could you just clear that up for me?

Mr. GRAMLICH. Yes. I have mandated that all of those accounts are annuitized because there is what is known as a self-selection problem in the private annuity market that only the people who expect to live a long life will get annuities and the insurance companies charge for that. I would like to break out of that by saying that everybody must annuitize the accounts, and so therefore you would not have that load charge, the self-selection load charge, and so you could annuitize the accounts at actuarially accurate rates. That is the point there. So they would be publicly annuitized in that sense.

Mrs. KENNELLY. Thank you for clearing that up. Dr. Schieber, are you concerned about people outliving the benefits in the PSA accounts, because you do not require annuities, and that concerns me, especially with regard to women. We women live forever.

Mr. SCHIEBER. In the report, we indicated that this was what we thought was a political consideration. That it would possibly make sense to require that benefits up to one and a half times, two times, the poverty line or something of that sort be annuitized. We did not know at what level that should be set. We thought that was a political decision. Our sense was that having studied how some of these processes evolved in the past that people would take our framework if they were interested in our framework and try and craft legislation around it, and this was an issue that we, I think, highlighted in the report and said that it was one that deserved political consideration. Personally I think it might make sense to require some annuity, some annuitization of that PSA, to make sure that people do not go off and spend their money too aggressively early on and then end up back on the public dole. But we did not know where to set that in our deliberations. We certainly did not rule it out. We were quite specific in the report saying it is a consideration.

Mrs. KENNELLY. I have another concern. We see incredible amounts of money now going into mutual funds, into the market. And it is thought that it is the baby boomers putting it in because they are thinking about their retirement. What concerns me is these same baby boomers—we know exactly who they are—46 to 64—when they retire and they start pulling the money out, what happens to the market there when everything is—you know, it is like if everyone sells their house at once, the price drops. What happens here?

Mr. SCHIEBER. This is an idea that is meant to haunt me for the rest of my life. Professor John Shoven at Stanford University and I wrote a paper on this 2 or 3 years ago that has come to be known as the "asset meltdown paper" that has been widely written about. The issue is whether or not during the baby boom generation's retirement there is a continued net saving going on in the economy. If there is continued net saving going on, then there will be people to buy up the assets that the baby boomers, in effect, are selling during their retirement period.

Now, we have written a subsequent paper I would be happy to share with you. One of the things we believe is that if you were to go to a more aggressive funding program of the sort that we have, you would really ameliorate that concern. But financial markets are far more dynamic than the housing market that you suggest. My own guess is that we are going to have problems in the housing market when the baby boomers dump all their assets. I think it is much less likely that you are going to see that in the financial markets.

Mr. GRAMLICH. Could I say a word about that?

Mrs. KENNELLY. You have to do it quick. The light is on.

Mr. GRAMLICH. OK. But he used all the time. The baby boomers are not all the same age. It is not like all baby boomers hit retirement in the same year. You will have the early boomers selling their stock when the later boomers are still accumulating, and so the baby boom does happen over a 30-year span. The other thing is that unlike housing, financial assets are traded in a worldwide market these days, and there are other countries coming along who have population bursts that are younger than our baby boomers, and so these assets can be traded on an international market and not necessarily have the people take a loss in the asset when they sell it in retirement. So I happen to think that the asset meltdown is overblown. Assets are not going to melt down that much.

Chairman BUNNING. Richard.

Mrs. KENNELLY. Thank you, gentlemen.

Mr. NEAL. Thank you, Mr. Chairman. As is not the case here, often many of the panels that we have, the people that come before the Members of the Congress, are oftentimes chosen because they have certain political views, and both sides have been part of this strategy for an awful long time, but I think that these sessions that Chairman Bunning has provided us with are very helpful. It does encourage us to think in larger terms than we are used to around here. I do think that your presence here today is indeed very helpful.

Let me raise again, a very important part of this discussion. What are we going to do about those 19 million Americans who do not have pensions?

Dr. Gramlich.

Mr. GRAMLICH. I think that you ought to mandate that they save 1.6 percent on top of Social Security.

Mr. SCHIEBER. Or that they fund a significant portion of their Social Security accumulation.

Mr. BALL. I think it is terribly important that Social Security be maintained at its present level because this is the only retirement that these people have and that they can count on. It is the base for everybody, but for one-half of the American workers, it is the only retirement system. It is not adequate in itself, but it certainly does not do any good to cut it back.

Mr. NEAL. I think that is interesting because if I might just put in a plug, too, that I think we tend to forget how successful Social Security has been. I think there are some legitimate criticisms about the reach of some of us on our side of the aisle, but it is also hard, I think, not to come to grips with the reality of how we change the lives of millions of senior citizens who until Social Security occurred lived in abject poverty. That has been lost in this discussion. We tend to treat this as though it is abstract.

Mr. SCHIEBER. No, I am not sure that is correct.

Mr. NEAL. Feel free to disagree.

Mr. SCHIEBER. I think if you looked at the deliberations within the Council, there was no one suggesting that we cast the public back to a pre-1935 environment. I think we were very cognizant of considerations about the low-income population. That led in the development of the program that Professor Gramlich talked about. He protects benefits for low-income people to a much greater extent than he does high income people. If you look at the characteristics of our plan, that is exactly the same case. I think we were very cognizant of the safety net, and even those of us that suggested somewhat significant changes from the existing system, we did not abandon the traditional goals of this program, and I think anyone—there are proposals out there that would do that, but no one on the Council that I know of seriously suggested that we take up those kinds of considerations.

Mr. NEAL. I did not mean to infer that you folks had done that. I think that oftentimes here in the abstract when we talk about these issues inside of the Congress, we tend to treat them with that sort of a proposition.

Mr. SCHIEBER. Right.

Mr. NEAL. I think that is dangerous. Let me just share one anecdote with you, and each Member of this Subcommittee, and I have not polled them about it. We frequently spend Fridays or Mondays with senior citizens. You attend a luncheon or you go to some sort of an event. People talk about the entitlement mentality, again in the abstract, but one of the things that always strikes me at those luncheons, particularly when you are dealing with people that are in their seventies or their eighties, if there is an extra piece of bread or whatever on the table, they do not leave it there. They wrap it up and take it with them. If there is candy, they wrap it up in a little napkin or whatever, and they take it with them. That is a terrific lesson about how their parents saw their lives 50 years ago, and it is a pretty important lesson for all of us as we begin down the road during this debate. And I do not think we should ever lose sight of just how successful Social Security has been.

Mr. SCHIEBER. And I agree, but I think we also cannot lose sight of the people who have to support it and the burden that it imposes upon the backs of labor. All of the people who come to these sessions or the overwhelming majority of them that you are talking about have children and grandchildren, and they are all part of the equation, and I think, what we toiled with in the Advisory Council was trying to figure out how to balance this equation fairly, and some of us came out with different conclusions than others, but it does not mean that we were not cognizant of the concerns about the elderly.

Mr. NEAL. Thank you. Thank you, Mr. Chairman.

Chairman BUNNING. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. It is on that note, Dr. Schieber, that I want to follow up with a question to both you and Dr. Gramlich, and it is really a question of advice on how we can marshal the forces of the younger generation, the Generation Xers. When Richard said he is at senior citizen centers on Fridays and Mondays, when we are not there, we are at high schools. When I am at the high schools one thing I talk about with these high school seniors, juniors, and sophomores is about generational equity and the Social Security system, and we have the best discussions with these young adults. Mr. Bunning earlier said that in the polls more of them believe in UFOs than actually seeing their Social Security ever come back to them. What can we do to marshal the forces of those 16- through 25-year-old individuals who are not in tune politically, who do not go to the polls to vote, but are giving 25 to 30 to 40 percent of their little pay stub, their paycheck, every other week, to Washington, and they have no idea where it is going, and they are never going to see it again? They are frustrated. They are mad.

I have thought about the Internet system, maybe some way we can hook them in and marshal them through that way and get them to be a force like the senior citizens groups are. I am open for ideas and I would like to hear both of your comments.

Mr. SCHIEBER. The only thing I can suggest having lived through two teenagers is maybe MTV.

Mr. GRAMLICH. I am going to try a more serious answer. Earlier, one of you, I think it may have been Congressman Bunning, asked us what is the important date to act, and we all said that we ought to act now. That is one of the things that we agree on. I happen to think that the people out there are probably more interested in action than they are in words, and I think that the best thing that could be done by the Congress to assure national faith in the retirement system in the years ahead is a far-reaching, future-oriented plan that puts retirement saving on a more solid basis than it is right now.

We have proposed three options. There are other options, but the present system does have to be shored up, and the way it is shored up is by you people, and so I would think that you would want to get cracking on it.

Mr. SCHIEBER. One of the things about this UFO issue that keeps getting raised in this discussion, some people attribute it to cynicism. My guess is that for the overwhelming majority of people, the one thing that they see each year about the financing situation of Social Security is the headline that gets printed after the Trustees' Report is released, typically in April, and that Trustees' Report recently has been telling people when the system was going to deplete its trust fund. For many people when you tell them that a trust fund is going to be depleted and it is backing something that is a benefit that is being promised to you, and that falls within your life expectancy, I think it is not unnatural that people would conclude that, hey, that is probably not going to be there for me. They do not understand the point that Bob Ball made a little while ago that even when we run out of money in the trust fund, there would still be 75 percent of benefits paid by current taxation.

I will come back. I agree with Ned. I think it is time for us to try and get this thing solved so we can go to our constituencies and we can say we have put this on a sound financial basis. There will be money in the bank when you get to retirement. There will be something to support your benefits. Action is what is important now.

Mr. CHRISTENSEN. Well, I appreciate your testimony here, and I also appreciate the fact that you have spent so much time looking at this issue. Mr. Ball, do you want to say something?

Mr. BALL. Yes, I would like to comment on this. I agree with my two colleagues here that what we need to do is act and put the system once again on a completely balanced basis, but in the meantime, these young people are being given lots of misinformation. It just is not true that they are not going to get their money back. One of the common points that the Council all agreed on was that this idea that Social Security is not going to be there when they retire is wrong. That is one of the common points that all 13 members——

Mr. CHRISTENSEN. Mr. Ball, if I could have Dr. Schieber's response to that.

Mr. SCHIEBER. The problem is that they are not going to become well-developed students of the financing of this program, and when we publish reports annually saying we are going to deplete the trust fund within their life expectancy, then they begin to question seriously whether we are telling them the truth about these promises. I think it is relatively simple.

Mr. CHRISTENSEN. Mr. Chairman, I know I have gone over my time, but I think we owe the younger generation of this country, the Generation Xers, if you want to call them that, information, some kind of information that they know what they could be earning, what they could be receiving if they were just getting some kind of interest rate that was respectable versus the type of 2- and 3-percent returns we see, and what kind of money they could expect at age 65 versus what they are going to see at age 65 based upon the current system, and somehow we have got to engage the Generation Xers into this fight because it is their backs, as Dr. Schieber said. They are paying and they are carrying this debt and I think that they are getting highly unfair treatment in this whole organization.

Chairman BUNNING. Thank you, Mr. Christensen. I would just like to sum up and thank the panel for their input and for their many years of work in developing three different alternatives for consideration. I fully understand having 30 grandchildren what Mr. Christensen is talking about. Even some of my own children wonder about the Social Security system being fully funded. They do not realize the amount of dollars that would be there even if we depleted all the reserves as we go beyond 2029.

In closing this first hearing, we really want to thank you. You have made recommendations. The Advisory Council has spent more hours than anyone looking at the many problems and many solutions to the problems of Social Security. Your findings have been instrumental in bringing Social Security challenges to the forefront of public discussion. If we could get bipartisan support for any of your plans, and I am talking about bipartisan support out of this Subcommittee, out of the Full Committee, we could move forward. We did not do that with Medicare, and therefore there was unbelievable conflict during the election cycle that just passed, one side blaming the other side for cuts in Medicare. To get consensus on Social Security, it is going to take not only your help, but the help of many others who are involved. As our series of hearings on the future of Social Security moves forward, we are going to get a lot of other opinions besides the ones that you have expressed today. We will hear from advocacy groups like the AARP or the National Committee to Preserve Social Security and Medicare, the Heritage Foundation, the Cato Institute, for example.

I want to thank you for your appearance today and getting us off to a good start. The hearing stands adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned, to reconvene on Thursday, April 10, 1997, at 10 a.m.]

THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT

THURSDAY, APRIL 10, 1997

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10 a.m., in room B–318, Rayburn House Office Building, Hon. Jim Bunning (Chairman of the Subcommittee) presiding.

Chairman BUNNING. Good morning. Today we continue our series on the Future of Social Security for this Generation and the Next.

Before we get underway, I would like to focus on an issue which has caught the attention of many deeply concerned Americans, including Mrs. Kennelly and myself. That is the Social Security Administration's new online access to personal earnings and benefit statements via the Internet.

Thankfully, yesterday afternoon the Social Security Administration announced that, in response to public outcry, the service was being suspended. While I appreciate SSA's desire to provide fast and expedited service, that service should never compromise the privacy of Americans. Public confidence in the Social Security system is based on trust, and Americans trust that their records will be kept safe and secure.

I have asked SSA's Inspector General to thoroughly investigate this service and report to the Subcommittee by April 22. I then plan to conduct a full oversight hearing on this activity.

Now back to the matters at hand. The focus of this second hearing is to establish a framework for evaluating options for Social Security reform. Our first hearing focused on the three plans proposed by the Advisory Council on Social Security. Future hearings in this series will include testimony from a wide variety of groups and individuals regarding their views on Social Security reform.

To prepare us for these hearings, I think it is imperative that we learn about the impact of the various plans for reform, how changes to the current system will affect the economy, national savings, the Federal budget, and the retirement security of every participant. Some of the proposals may sound like simple solutions, but each has underlying complex issues that cannot be overlooked.

As the Subcommittee has agreed, we are going to be thorough in our investigation into Social Security reform.

Today we look forward to hearing the perspectives of the Congressional Research Service, the General Accounting Office, and four distinguished experts.

In the interest of time, it is our practice to dispense with opening statements, except for the Ranking Democrat Member. All Members are welcome to submit statements for the record.

I yield to Congresswoman Kennelly for any statement she wishes to make.

Mrs. KENNELLY. Thank you, Mr. Chairman. Thank you for your opening statement concerning Social Security and privacy. And I would suggest probably that if the Social Security Administration had let us know of their intentions, it would have been a good idea because we might have been more helpful if we had known it earlier.

I am pleased the Subcommittee is holding the second in a series of hearings on the future of Social Security. During these hearings we will examine more carefully the options of Social Security reform.

There is no escaping the demographics of the 21st century. With the retirement of the baby boom generation, fewer workers will be supporting more retirees. Not only will the group reaching retirement be larger, but they will be living longer. These demographics present us with an enormous challenge. The challenge is to provide an adequate retirement income for tomorrow's retirees without reducing the standard of living of younger generations.

The Social Security Advisory Council has given three options for reform. We are also receiving other options. Our witnesses today have analyzed many of these plans and they will give us their views on the fundamental issues which need to be addressed as part of any Social Security reform and they will give us answers to several critical questions. Do we need to increase national savings? If so, how can we accomplish this? What impact will these proposals have on the Federal deficit? What will happen to the current protections which Social Security offers to retired and disabled Americans? Will private investment in retirement funds increase the risk that individuals will have inadequate retirement income?

I am particularly interested in the impact of these proposals on women. I have asked the General Accounting Office to look at the labor force participation patterns of women and the impact of those patterns on the retirement income of women. In addition, I have asked GAO to compare the protections of the current Social Security and pension systems to the protections offered by the three Advisory Council plans.

GAO's conclusion must give us pause. The analysis raises serious questions about a new system which strips away the current protections provided by Social Security and replaces them with private investment accounts. Surely we do not want to move toward a system which increases the inequities in retirement income.

I appreciate the work the GAO has done and I look forward to hearing from each of today's witnesses. Thank you, Mr. Chairman.

Chairman BUNNING. Today we will begin with testimony from David Koitz from the Congressional Research Service. He is a specialist in the Social Legislation, Education and Public Welfare Division of CRS. If you'll join us at the witness table, you may begin.

STATEMENT OF DAVID KOITZ, SPECIALIST IN SOCIAL LEGISLATION, EDUCATION AND PUBLIC WELFARE DIVISION, CONGRESSIONAL RESEARCH SERVICE

Mr. KOITZ. Mr. Chairman and Members of the Subcommittee, I was asked to speak to you about some of the issues involved in putting together a long-range Social Security reform. Obviously for this Subcommittee, the primary question about any proposal, is does it make the system solvent? For this, the task is figuring out what combination of changes will erase the system's 75-year deficit and keep a balance in the trust funds throughout the period.

Two of the three recent Advisory Council plans—the Gramlich and the Schieber/Weaver plans—pass this test and the third—the Ball plan—could be deemed to do so if its proponents' suggestion to invest some of the trust funds in equities were considered part of their plan.

While trust fund solvency is important, how a plan affects the Government as a whole also needs to be considered. Social Security's financial operations are accounted for separately through trust funds, but the money is not kept separate, no more so than a bank keeps your money separate when you make a deposit. Social Security money goes into and out of the U.S. Treasury and, as such, it affects the overall financial flows of the Government.

Two of the three Advisory Council proposals would increase budget deficits for as many as 30 years, one by modest amounts—that would be the Ball plan; the other by large amounts—that would be the Schieber/Weaver plan. If one thinks about the struggle that Congress and the President are having now over achieving $400 to $500 billion in cumulative deficit reductions by 2002, it is hard to comprehend how a gap of two or more times that size would be dealt with. The Schieber/Weaver plan would create such a gap.

What a plan does to the level of future government spending—that is, when the baby boomers are in retirement—is another consideration. Medicare and Medicaid spending, in conjunction with Social Security, is projected to rise from about 8.5 percent of GDP today to 16 percent in 2025. Changes in Social Security can affect the potential strain that this increase may cause.

In this regard, the Advisory Council's three plans provide a range of impacts. The Ball plan reduces Social Security's average costs by 2 percent, the Gramlich plan by 13 percent and the Schieber/Weaver plan by 30 percent.

The impact the plan has on national savings is yet another consideration. Some would contend that diverting Social Security money into the financial markets will increase savings. However, if there are no accompanying revenue increases or spending cuts, the Government simply has to borrow the money to make up for the foregone revenues. With one hand it invests; with the other hand it borrows; on balance, there is no change.

Moreover, if people refrain from saving elsewhere—for instance, in their 401(k)s—because part of their Social Security taxes are going into market-based accounts, part of any positive impact on savings is lost.

The Gramlich plan raises Social Security receipts and cuts spending and also mandates a 1.6-percentage point increase in payroll withholding for private accounts. Both parts of this plan could raise savings, although a portion of the 1.6-percent set-aside might be offset by reductions elsewhere.

The other two plans also would make large investments in the markets, but only part would be financed with revenue increases and spending cuts. The other part would be financed with government borrowing. When you add this new government borrowing together with possible reductions in voluntary savings, it is unclear what their net savings impact would be. The idea of introducing a market element to Social Security also trades off greater risk for greater rewards. Even a passive investment fund, using a market-index approach, still carries risk.

The three Advisory Council plans were priced assuming more than 11 percent annual rate of return based on the performance of the stock market from 1900 to 1995. However, much of this success is the result of what the equities market did in the last 13 years. The Dow-Jones stood in the 800 to 1,000 range from 1964 to 1982. At the end of 1995, it stood at 5,117. Since 1950, the average return on the S&P 500 index was almost twice that of the Social Security trust funds, but in 20 of those 47 years, it underperformed the trust funds.

In other words, if one were depending on the market to give the trust funds a bigger boost over the next decade or two, there is the possibility it would not happen.

I am not trying to minimize the market's potential to enhance investment returns for the system or for individuals. Certainly a broad based, buy-and-hold strategy practiced over the working lifetimes of most retirees today would have been very rewarding. The point here is only that there is more risk.

On another level, I would point out that there is a tendency by many to suggest that economic growth is the panacea to Social Security's problems. Its problems, however, are not simply a savings or financing issue. They reflect a broader change confronting society; namely, that there will be considerably fewer workers for each retiree in the future. A plan that makes working more attractive than retiring and encourages employers to retain older workers may be as important as how effectively it restores balance to the Social Security trust funds.

Finally, no plan will effectively address the Social Security problem unless it addresses the public's current lack of confidence. It may be that the most valuable feature of a plan that allows workers to invest part of their Social Security taxes in the markets is that it would give them a greater sense of ownership of the system. On the other hand, a plan that relied on traditional fixes—of raising revenue and cutting spending—could achieve a similar result if it stood the test of time. Arguably, the 1983 Social Security amendments failed the latter.

[The prepared statement and attachments follow:]

Statement of David Koitz, Specialist in Social Legislation, Education and Public Welfare Division, Congressional Research Service

Mr. Chairman and Members of the Committee, I was asked to speak to you about some of the basic issues involved in constructing a long-run Social Security fix. I am not here to put forward any single proposal or point of view. As requested, my purpose is to attempt to provide some sort of framework under which you may consider various options. You might think of the 8 questions I'm about to pose as a checklist. Congress is often asked to focus on proposals, i.e., on the changes themselves, and the underlying policy concerns emerge only in a piecemeal fashion. The recent Social Security Advisory Council, for instance, presented you with three different plans, but as many of you already recognized in your previous hearing, they spent 2 years contemplating the underlying issues. The multitude of things they considered are in their report but are presented from the opposing points of view of the various factions. I'm going to try here to set out some issues without coming to a conclusion about which plan best addresses them.

1. Do the trust fund numbers balance?

Obviously for this Subcommittee, given its stewardship of Social Security, the primary question about any proposal is does it make the Social Security trust funds solvent over the long run. For this, the task is figuring out what combination of proposals will eliminate the average 75-year deficit reported by the trustees and keep a balance in the trust funds throughout the period. In the past, this was the predominant criterion used by this Committee. Two of the 3 Advisory Council plans—the Gramlich and Schieber/Weaver plans—pass this test, and the third—the Ball plan—arguably could be deemed to do so if its "suggestion" that part of the trust funds be invested in equities were considered a recommended change.

2. Is the Government's overall deficit reduced (or at least left unaffected)?

Given the emphasis that Congress and the President are placing on eliminating federal budget deficits and halting the growth of the federal debt, the financial well-being of the government as a whole needs to be considered. Some of the plans presented to you would achieve long-range actuarial balance of the Social Security system, but they also would increase the imbalance between the government's income and outgo. Simply put, Social Security receipts and expenditures are accounted for separately through federal trust funds, but the money is not kept separate—no more so than a bank keeps your money separate when you make a deposit to your checking account. Social Security money goes into and out of the U.S. Treasury, and thereby affects the overall financial flows of the government.

Two of the 3 Advisory Council proposals would increase budget deficits for as many as 30 years—one by modest amounts (the Ball plan), the other by large amounts (the Schieber/Weaver plan). They would do so by diverting Social Security receipts into investments in the nation's financial markets. If one thinks about the struggle Congress and the President are having over achieving $400 to $500 billion in cumulative deficit reductions by 2002, it is hard to comprehend how a gap of two or more times that size would be dealt with. One of the plans (the Schieber/Weaver plan) would create such a gap. Over its first 10 years, it cumulatively would divert $1.8 trillion into the markets by diverting 5 percentage points of the Social Security tax rate into personal accounts. Even more modest set-asides of 1.5 to 2 percentage points of the Social Security tax rate would mean large revenue diversions from the Treasury. Two percent of payroll is equal to $65 billion a year today, $75 billion in 2000, and $95 billion in 2005.

3. Is the overall growth of entitlement programs affected?

Examining what a plan does to the overall level of government spending is another important measure of fiscal impact. Ultimately, the overall level of federal taxation is driven by the overall level of government spending, even if not dollar for dollar. If Social Security were made solvent primarily through future revenue increases, or for argument's sake, infusions from the general fund to the trust funds, there would be no reduction in the burgeoning spending on entitlements arising from the retirement of the post World-War II baby boomers and a rapidly aging population. Under current projections, Medicare and Medicaid in conjunction with Social Security would rise from 8.5% of GDP today to 16% in 2025. Social Security does not function in a fiscal vacuum; it is part of the government; and changes to it can affect the long-run fiscal strains posed by all major entitlement programs. In this regard, the 3 Advisory Council plans provide a range of impacts: one reduces Social Security's projected long-range cost by 2% (the Ball plan); a second reduces it by 13% (the Gramlich plan); and the third by 30% (the Schieber/Weaver plan).

4. Are national savings increased (or at least left unaffected)?

Some proponents of investing Social Security money in the financial markets see it as a means of increasing national savings. However, diverting Social Security funds into the markets by itself does little or nothing to savings. If there are no accompanying federal revenue increases or spending cuts, the government simply has to borrow the money to make up for the foregone revenues. With one hand it invests (or mandate that individuals invest), with the other hand it borrows—on balance there is no change.

Other proposals raise Social Security receipts and/or constrain Social Security spending. In so doing, they reduce government deficits and thereby reduce what the Treasury has to borrow from financial markets (or perhaps some day reduce the outstanding federal debt held by the public). More money in the financial markets should make more money available for private investment. Economists would say that tax increases and spending constraints are likely to cut consumption and, thus, increase savings.

Still other plans would raise Social Security receipts and/or constrain Social Security spending, but then divert funds into the markets either by investing a part of the trust funds in them or requiring individuals to do so with part of their Social Security taxes. Certainly, the first part—raising taxes and/or constraining spending—reduces deficits and government borrowing, and potentially raises savings. What happens because of the diversion of funds into private accounts, on the other hand, is less certain.

If people refrain from retirement saving they would otherwise do because they believe a part of their Social Security taxes now are going into market based accounts with higher returns, especially if these investments belong to them personally, part of any positive impact on national savings would be lost. For instance, if some people stop making payments to their 401(k)s, on balance they may not be saving more. One of the Advisory Council's plans, the Gramlich plan, raises Social Security receipts and cuts spending—economists would say that part potentially increases savings. It also would mandate a 1.6% increase in payroll withholding that would go into private individual accounts. That too potentially raises savings (by cutting consumption), but the amount by which it does so is unclear because some of this mandatory saving could be offset by reductions in voluntary savings. The other two Advisory Council plans would make substantial investments in the markets (one much more than the other), part of which would be financed with a combination of Social Security revenue increases and spending constraints and part with government borrowing. As with the Gramlich plan, the part that increases receipts and constrains spending could raise national savings. However, if some substantial part of the money diverted to the markets is offset by decisions to save less elsewhere, it is unclear what the net savings impact would be, particularly under the Schieber/Weaver plan which mandates the creation of large individual retirement accounts.

5. How much risk/reward should the future Social Security system assume?

The idea of introducing a market element to Social Security raises the question of trading off greater risk for greater rewards in planning for future retirement. Although actuarial projections of the effects of the Advisory Council proposals assume greater rates of return from market investments than the trust funds or individuals would earn from Social Security, there is no guarantee. Timing as well as investment choices are critical. Even a passive investment fund, using a market-index approach so as to minimize the risks of poor investment choices, still carries more risk.

The 3 Advisory Council plans were priced assuming more than an 11% annual rate of return based on the performance of the stock market over the 95-year period, 1900–1995. However, much of this long-range average is based on what the equities market did in the last 13 years. The Dow Jones stood in the 800–1000 range from 1964 to 1982; on December 31, 1995, it stood at 5,117. Looking back at the performance of the S&P 500 index since 1950, its annualized average rate of return was almost twice that of the Social Security trust funds (11.36% versus 5.96%); but in 20 of those 47 years, it underperformed the trust funds. There were 7 years in which its 10-year moving average underperformed the trust funds. In other words, if one were depending on the market to give the trust funds a considerably bigger boost over the next decade, or the following decade, there is the possibility that the market will not meet that expectation and may even underperform the traditional means of investing Social Security funds.

The point here is not to minimize the market's potential to enhance the expected returns for the Social Security system or for individuals using market-based retirement accounts. The longer the period, the greater the likelihood the market will do so. Since 1970, the 30-year moving average of the S&P 500 outperformed the trust funds in every year. Certainly, a broad-based, buy-and-hold strategy practiced over the working lifetimes of most retirees today would have been very rewarding. The point is only that there is more risk. U.S. equity markets have prospered steadily for the past 15 years, and this may or may not continue. Their performance has been so robust that some analysts would suggest that we may be experiencing the top of an historic bull market. The crucial decision for policymakers is how much risk to allow in the development of Social Security in the future.

6. How is the ratio of future workers to non-workers affected?

There seems to be a preoccupation among many who look at Social Security to see economic growth as the panacea to its problems. However, Social Security's problems are not simply a savings or financing issue. They are a reflection of a broader issue confronting society, namely that 25 years from now there will be considerably fewer workers for each non-worker. An important question with any Social Security fix is how does it potentially affect choices about continuing to work late in one's career. A plan that makes working more attractive than retiring and encourages employers to retain older workers while accommodating their increased desire for leisure may be as important as how effectively it restores balance in the Social Security trust funds. The extent to which the various Advisory Council factions considered this perspective in the development of their plans is unclear.

7. What long-run level of retirement income is desirable?

While the budget and macro-economic effects of any plan are important, the impact a plan has on future retirees' income has to be part of the equation. Under current projections Social Security receipts would cover roughly 75% of the cost of the system once its reserves are depleted in 2029. Hence, a plan that avoids future tax and revenue increases and relies exclusively on constraining Social Security benefits would reduce the relative size of future benefits by about 25%, assuming the constraints were equally spread throughout the Social Security benefit package.

Keep in mind, however, that current-law projections already anticipate constraints on future Social Security benefits resulting from a scheduled increase in the so-called normal retirement age from 65 to 67. Thus, a cut in future benefit levels would have to be on top of this. A Social Security fix that relies exclusively on benefit constraints would reduce the relative benefit level of a 2030 retiree (i.e., the percent of the retiree's final earnings replaced by benefits) by more than 35% from what it is for someone retiring today. This is not to suggest that if today's workers choose later retirement ages than today's retirees, today's benefit levels couldn't be sustained; but compared to the relative benefit levels at retirement ages typically chosen today, i.e., 62–65, they would have to be more than 35% lower.

Although the 3 Advisory Council plans assume different mixes of traditional Social Security and private retirement savings, they generally aim for a combination of the two that approximate the Social Security benefit levels projected under current law. In other words, embedded in their plans is the premise that the level of future retirement incomes does not have to (or perhaps should not) be reduced beyond what is scheduled under current law.

8. Is public confidence in the system bolstered?

Finally, no plan will effectively address the Social Security problem unless it addresses the public's current lack of confidence. The 1983 amendments brought major changes to Social Security, but did not have a lasting effect in restoring public confidence. It may be that the most valuable feature of a plan that would allow individuals to invest part of Social Security in the markets is that it would give them a greater sense of ownership of the system. On the other hand, a plan that relied on traditional fixes of raising revenue and cutting spending could accomplish a similar result if it stood the test of time. Arguably, the problem with the 1983 amendments is that they failed the latter. At the time of enactment, the system's average 75-year deficit was projected to be eliminated. Congress, however, did not examine whether the system's income and outgo were matched over the long haul—they weren't, but there were no year-by-year projections made at the time of deliberation. Consequently, there was little understanding that after a period of surpluses, there would be an indefinite period of deficits that eventually would throw the system back into actuarial imbalance. Another problem is that no cushion was built into the 1983 changes in case the projections proved overly optimistic, which they did.

The Advisory Council's 3 proposals do not reflect the full range of options

In response to a question asked by Representative Johnson in your last hearing, the witnesses from the Advisory Council stated that they had explored the full gamut of options. Certainly, their 3 plans contain wide ranging differences. However, they have a number of fundamental similarities as well. None is voluntary—they all require workers to participate even in their market-based components. None uses a means test—all base benefits on employment and contributions records, not on need. None totally eliminates the system's social features—all retain a tilt that favors lower income workers. None relies on general taxation. Although one borrows heavily from the government's general fund, workers' taxes and contributions remain the dominant means of financing. Finally, all rely on some form of increased taxation (or payroll withholding) to reform or restore the system to solvency.

I think this last similarity is important in illustrating that the panel's three proposals do not reflect a full range of options. Outside of the Council, there have been a number of plans suggested to address the system's problems without tax increases. Those that contain a market-based component carve it out of the existing tax base. They would earmark a piece of the existing Social Security tax rate for individual investment. The plans offered by the Advisory Council range from doing as little as possible to alter the system's benefits (the Ball plan) to adopting a fundamentally new system (the Schieber/Weaver plan). In between is the Gramlich plan which would retain but reduce the cost of the current system and then mandate a 1.6-percentage-point increase in payroll withholding for private retirement accounts. None of the Council's options would reduce the cost of the current system and then carve out a piece of the existing tax rate for private accounts. I am not suggesting such a change nor that it avoids the issues raised by the Advisory Council's plans, but just pointing out that the range of options is more complete with it. If Congress does not want wholesale reform, does not want to raise payroll withholding, and wants at least some market-based component added to the system, this fourth approach becomes relevant. It certainly becomes relevant if for no other reason than it, unlike any of the Advisory Council's three approaches, has been introduced by Members of Congress in one form or another.

TABLE 1. IMPACT OF 1994–96 SOCIAL SECURITY ADVISORY COUNCIL'S PROPOSALS ON FEDERAL DEFICITS AND THE FEDERAL DEBT HELD BY THE PUBLIC

[$S IN BILLIONS; (+)=increase, (−)=decrease]

	Impact on federal deficits			Impact on Federal debt held by the public		
Calendar year	Maintain benefits (Ball plan)	Individual accounts (Gramlich plan)	Personal security accounts (Schieber/Weaver plan)	Maintain benefits (Ball plan)	Individual accounts (Gramlich plan)	Personal security accounts (Schieber/Weaver plan)
1998	−5	−4	+101	0	0	0
1999	−8	−5	+121	−5	−4	+101
2000	+13	−8	+137	−13	−9	+223
2001	+13	−11	+155	−1	−17	+360
2002	+13	−16	+175	+12	−28	+515
2003	+13	−23	+192	+25	−44	+690
2004	+13	−31	+211	+37	−67	+882
2005	+13	−39	+231	+50	−98	+1093
2006	+15	−48	+248	+63	−137	+1324
2007	+18	−58	+263	+78	−186	+1571
2008	+22	−67	+277	+96	−244	+1834
2009	+25	−77	+288	+118	−310	+2111
2010	+29	−89	+301	+143	−387	+2400
2011	+32	−103	+311	+172	−477	+2701
2012	+34	−119	+320	+204	−580	+3012
2013	+36	−136	+325	+238	−699	+3332
2014	+35	−157	+330	+274	−835	+3657
2015	−106	−181	+333	+309	−992	+3987
2016	−131	−211	+329	+203	−1173	+4320
2017	−160	−245	+322	+72	−1384	+4648
2018	−193	−284	+311	−88	−1630	+4970
2019	−229	−326	+298	−281	−1914	+5281
2020	−269	−372	+282	−509	−2240	+5580
2021	−314	−416	+264	−779	−2612	+5862
2022	−363	−463	+243	−1093	−3028	+6125
2023	−416	−513	+218	−1455	−3490	+6368

TABLE 1. IMPACT OF 1994–96 SOCIAL SECURITY ADVISORY COUNCIL'S PROPOSALS ON FEDERAL DEFICITS AND THE FEDERAL DEBT HELD BY THE PUBLIC—CONTINUED

[$S IN BILLIONS; (+)=increase, (−)=decrease]

	Impact on federal deficits			Impact on Federal debt held by the public		
Calendar year	Maintain benefits (Ball plan)	Individual accounts (Gramlich plan)	Personal security accounts (Schieber/Weaver plan)	Maintain benefits (Ball plan)	Individual accounts (Gramlich plan)	Personal security accounts (Schieber/Weaver plan)
2024	−474	−568	+190	−1871	−4003	+6587
2025	−536	−629	+158	−2345	−4571	+6777
2026	−603	−700	+123	−2881	−5200	+6935
2027	−673	−778	−84	−3484	−5900	+7058
2028	−749	−864	−40	−4157	−6678	+7141
2029	−829	−958	+9	−4906	−7542	+7181
2030	−914	−1062	+63	−5734	−8501	+7172

Source: Analysis by Stephen C. Goss, Deputy Chief Actuary, Office of the Actuary, SSA, based on assumptions underlying the Intermediate projections of the 1995 OASDI Trustees' Report. Report of the 1994–1996 Advisory Council on Social Security. Volume 1, Table UB.

TABLE 2. COMPARISONS OF TOTAL RETURNS OF S&P 500 INDEX TO EFFECTIVE YIELDS EARNED BY SOCIAL SECURITY TRUST FUNDS, YEAR-TO-YEAR PERFORMANCE, 1950–1996

[ANNUAL RATE OF RETURN]

Calendar year	S&P 500	Social Security trust funds	S&P 500 outperformed Social Security trust funds? (Yes)/(No)
1950	27.35%	2.02%	yes
1951	21.6%	2.89%	yes
1952	16.58%	2.24%	yes
1953	−1.82%	2.31%	no
1954	48.97%	2.30%	yes
1955	29.48%	2.20%	yes
1956	5.71%	2.40%	yes
1957	−10.96%	2.49%	no
1958	41.03%	2.52%	yes
1959	10.71%	2.58%	yes
1960	−0.50%	2.60%	no
1961	25.11%	2.76%	yes
1962	−9.44%	2.83%	no
1963	21.06%	2.92%	yes
1964	14.98%	3.08%	yes
1965	11.06%	3.18%	yes
1966	−10.69%	3.48%	no
1967	22.29%	3.75%	yes
1968	9.73%	3.95%	yes
1969	−9.12%	4.44%	no
1970	2.93%	5.07%	no
1971	12.93%	5.29%	yes
1972	17.47%	5.41%	yes
1973	−15.31%	5.75%	no
1974	−26.25%	6.22%	no
1975	34.86%	6.59%	yes
1976	21.92%	6.73%	yes
1977	−7.88%	6.96%	no
1978	5.34%	7.20%	no
1979	16.78%	7.52%	yes
1980	30.03%	8.57%	yes
1981	−5.53%	9.95%	no
1982	19.57%	11.18%	yes
1983	20.67%	10.77%	yes
1984	5.04%	11.60%	no

TABLE 2. COMPARISONS OF TOTAL RETURNS OF S&P 500 INDEX TO EFFECTIVE YIELDS EARNED BY SOCIAL SECURITY TRUST FUNDS, YEAR-TO-YEAR PERFORMANCE, 1950–1996—Continued

[ANNUAL RATE OF RETURN]

Calendar year	S&P 500	Social Security trust funds	S&P 500 outperformed Social Security trust funds? (Yes)/(No)
1985	29.58%	11.21%	yes
1986	17.11%	11.09%	yes
1987	4.11%	10.06%	no
1988	15.04%	9.77%	yes
1989	29.70%	9.55%	yes
1990	−3.95%	9.30%	no
1991	28.55%	9.08%	yes
1992	6.45%	8.74%	no
1993	8.84%	8.32%	yes
1994	0.28%	8.03%	no
1995	35.67%	7.84%	yes
1996	21.16%	7.52%	yes

Note: Analysis of returns of the S&P 500 includes growth (or decline) in capital value and dividends paid, less a hypothetical 1% per annum to reflect administrative costs. Derived from Standard and Poor's Security Price Index Record, 1996 Edition.

Source: Analysis by Geoffrey Kollmann, Congressional Research Service, March 1997.

TABLE 3. COMPARISONS OF TOTAL RETURNS OF S&P 500 INDEX TO EFFECTIVE YIELDS EARNED BY SOCIAL SECURITY TRUST FUNDS, 10, 20, AND 30-YEAR MOVING AVERAGES

(ANNUALIZED RATE OF RETURN)

	10-year moving average, 1950–1996			20-year moving average, 1960–1996			30-year moving average, 1970–1996		
Calendar year	S&P 500	Social Security trust funds	S&P 500 outperformed Social Security trust funds? (Yes)/(No)	S&P 500	Social Security trust funds	S&P 500 outperformed Social Security trust funds? (Yes)/(No)	S&P 500	Social Security trust funds	S&P 500 outperformed Social Security trust funds? (Yes)/(No)
1950	11.52%	2.08%	yes	....	....	....	....	....	
1951	15.19%	2.13%	yes	....	....	....	....	....	
1952	14.99%	2.13%	yes	....	....	....	....	....	
1953	12.39%	2.15%	yes	....	....	....	....	....	
1954	15.07%	2.18%	yes	....	....	....	....	....	
1955	14.69%	2.20%	yes	....	....	....	....	....	
1956	10.85%	2.24%	yes	....	....	....	....	....	
1957	14.50%	2.30%	yes	....	....	....	....	....	
1958	18.05%	2.27%	yes	....	....	....	....	....	
1959	17.52%	2.39%	yes	....	....	....	....	....	
1960	14.65%	2.45%	yes	13.08%	2.26%	yes	....	....	
1961	14.98%	2.44%	yes	15.09%	2.28%	yes	....	....	
1962	12.11%	2.50%	yes	13.54%	2.31%	yes	....	....	
1963	14.49%	2.56%	yes	3.43%	2.35%	yes	....	....	
1964	11.56%	2.64%	yes	13.30%	2.41%	yes	....	....	
1965	9.86%	2.74%	yes	12.25%	2.47%	yes	....	....	
1966	8.02%	2.84%	yes	9.43%	2.54%	yes	....	....	
1967	11.51%	2.97%	yes	12.99%	2.63%	yes	....	....	
1968	8.74%	3.11%	yes	13.30%	2.69%	yes	....	....	
1969	6.62%	3.30%	yes	11.93%	2.84%	yes	....	....	
1970	6.98%	3.54%	yes	10.75%	3.00%	yes	11.01%	2.69%	yes
1971	5.89%	3.80%	yes	10.34%	3.12%	yes	11.93%	2.79%	yes
1972	8.68%	4.05%	yes	10.38%	3.27%	yes	11.90%	2.89%	yes
1973	4.87%	4.34%	yes	9.57%	3.44%	yes	10.50%	3.01%	yes
1974	0.31%	4.65%	no	5.79%	3.64%	yes	8.80%	3.15%	yes
1975	2.28%	4.99%	no	6.00%	3.86%	yes	8.82%	3.30%	yes
1976	5.51%	5.32%	yes	6.76%	4.07%	yes	8.11%	3.46%	yes
1977	2.56%	5.64%	no	6.94%	4.29%	yes	9.40%	3.62%	yes
1978	3.10%	5.96%	no	5.39%	4.53%	yes	9.45%	3.77%	yes
1979	4.74%	6.27%	no	5.68%	4.77%	yes	9.48%	3.97%	yes

TABLE 3. COMPARISONS OF TOTAL RETURNS OF S&P 500 INDEX TO EFFECTIVE YIELDS EARNED BY SOCIAL SECURITY TRUST FUNDS, 10, 20, AND 30-YEAR MOVING AVERAGES—CONTINUED

(ANNUALIZED RATE OF RETURN)

	10-year moving average, 1950–1996			20-year moving average, 1960–1996			30-year moving average, 1970–1996		
Calendar year	S&P 500	Social Security trust funds	S&P 500 outperformed Social Security trust funds? (Yes)/(No)	S&P 500	Social Security trust funds	S&P 500 outperformed Social Security trust funds? (Yes)/(No)	S&P 500	Social Security trust funds	S&P 500 outperformed Social Security trust funds? (Yes)/(No)
1980	7.22%	6.62%	yes	7.10%	5.07%	yes	9.56%	4.19%	yes
1981	5.32%	7.08%	no	5.61%	5.43%	yes	8.64%	4.42%	yes
1982	5.51%	7.65%	no	7.08%	5.84%	yes	8.73%	4.71%	yes
1983	9.31%	8.15%	yes	7.07%	6.23%	yes	9.48%	4.99%	yes
1984	13.25%	8.69%	yes	6.58%	6.65%	no	8.22%	5.30%	yes
1985	12.79%	9.15%	yes	7.41%	7.05%	yes	8.22%	5.59%	yes
1986	12.34%	9.59	yes	8.87%	7.43%	yes	8.59%	5.88%	yes
1987	13.72%	9.90%	yes	8.00%	7.75%	yes	9.16%	6.13%	yes
1988	14.73%	10.17%	yes	8.26%	8.04%	yes	8.42%	6.37%	yes
1989	15.94%	10.37%	yes	10.20%	8.30%	yes	8.99%	6.61%	yes
1990	12.48%	10.45%	yes	9.82%	8.52%	yes	8.86%	6.83%	yes
1991	16.00%	10.36%	yes	10.53%	8.71%	yes	8.96%	7.05%	yes
1992	14.66%	10.11%	yes	9.99%	8.88%	yes	9.55%	7.25%	yes
1993	13.48%	9.87%	yes	11.38%	9.01%	yes	9.16%	7.43%	yes
1994	12.96%	9.51%	yes	13.10%	9.10%	yes	8.67%	7.60%	yes
1995	13.48%	9.18%	yes	13.13%	9.16%	yes	9.39%	7.75%	yes
1996	13.86%	8.82%	yes	13.10%	9.20%	yes	10.51%	7.89%	yes

Note: Analysis of returns of the S&P 500 includes growth (or decline) in capital value and dividends paid, less a hypothetical 1% per annum to reflect administrative costs. Derived from Standard and Poor's Security Price Index Record, 1996 Edition.

Source: Analysis by Geoffrey Kollmann, Congressional Research Service, March 1997.

Chairman BUNNING. Thank you, Mr. Koitz.

Let me ask you just a couple of questions. You seem to be saying that to maintain the benefit plan along with the personal savings accounts plan of the Advisory Council, does not necessarily increase national savings. How did you reach that conclusion?

Mr. KOITZ. OK, I considered three parts of an equation. The PSA plan, for instance, would put roughly 5 percent of payroll, about $150, $160 billion a year, into the markets. Part of that would come from revenue increases or spending cuts that the Government would make, but part would come from borrowing.

So with one hand, we are putting $150, $160 billion into the markets; with the other hand, we are borrowing the money to do that. With one hand we put it in; with the other hand, we take it out.

The other thing is that most economists would expect some reduction in voluntary savings because the PSA plan is a mandatory approach. Over time, as amounts in these plans accumulate, people are going to say, well, I have a big pot of money growing over here in this PSA. I am also putting money into my employer's 401(k), or I am putting money into an IRA, or into a 403(b) or 457 plan. But I also have a big mortgage to pay. Maybe I have special medical expenses, kids' education, and so forth. Something may draw me away from that voluntary savings route that I was following.

So if you make an assumption that some of the net money going into the markets from the PSA investment is going to be offset by voluntary savings, you do not necessarily get an overall increase in the amount of money going into the markets.

Chairman BUNNING. That assumes that the person would then, who was voluntarily saving, would no longer voluntarily save; they would take more out of their 401(k) or other plan they might have.

Mr. KOITZ. Right.

Chairman BUNNING. Now, your testimony includes reference to the 1983 amendments. You say at the time Congress did not examine whether the system's income and outgo were matched over the long haul. You mention there was little understanding at that time that an indefinite period of deficits, mostly due to the aging baby boomers, would eventually throw the system back into actuarial imbalance.

How should we approach the problem differently this time around?

Mr. KOITZ. Well, the first part is really easy.

Chairman BUNNING. The first part is really easy, OK.

Mr. KOITZ. There was very little understanding of the year-to-year flow of funds emanating from the 1983 amendments. There was some discussion in the Greenspan Commission about there being surpluses, but it was not a long discussion.

When the plan was being developed here in this Committee and in the Finance Committee, there were no year-to-year projections. There were two principal goals. One was to get rid of the short-run problem, 1983 to 1989–90. Nobody wanted it to come back again.

In the long run, the focus was on the average 75-year deficit. For the short run, both Committees looked at pessimistic projections because they did not want to see the problem arise again in the near term. In the long run, however, they focused on what would be reported in the trustees' report and that was the average deficit.

So I think the easy part is that when you are developing a plan, you continuously look at what that plan will do year to year throughout the projection period. If that had been done in 1983, you would have seen that there was this huge buildup, a huge surplus, a huge trust fund balance building up in the early years and, then that income would be less than outgo in or around 2020 and 2025, indefinitely. So that is the easy part.

Chairman BUNNING. I ask this only because it is a topic of discussion on Capitol Hill from Mr. Greenspan to the Boskin Commission and others. In 1983 was the adjustment in the CPI a consideration at all?

Mr. KOITZ. We delayed the COLA by 6 months permanently.

Chairman BUNNING. No, I mean the change in determining in the CPI.

Mr. KOITZ. Not the measurement of the CPI itself.

Chairman BUNNING. So it was not discussed at all?

Mr. KOITZ. No, but I think it was just the year before that a major change was made in the treatment of the housing of the CPI. We went to a rental equivalency basis rather than a purchase price basis.

Chairman BUNNING. Mrs. Kennelly.

Mrs. KENNELLY. Thank you.

You have joined the club of a few who can talk about this important issue.

I am going to look at this issue from a slightly different angle. I know you gave us a great deal of information, but you note in your testimony that the diversion of 5 percent of the payroll tax from the trust fund into the private personal security accounts will increase the Federal deficit. Then you calculate that the increase in the deficit will be roughly $1.8 trillion in the first 10 years.

So I would like to come at this from a little different angle. Why doesn't the large reduction in the benefits in the PSA plan and the 1.5 percent increase in the payroll tax cover this so that we do not get that huge deficit change?

Mr. KOITZ. The PSA plan would immediately divert the 5 percent into the markets. The savings that come from its benefits changes and a few of the revenue items that it proposes are slow growing. So in the early years, you do not get much budget savings, so to speak, but you have a big revenue loss with the immediate nature of the 5 percent set-aside.

Mrs. KENNELLY. Let me follow up on that. How does this $1.8 trillion increase that you have talked about in the deficit compare to the increase in the deficit under Mr. Ball's maintained benefits plan, which invests a portion of the trust fund in the private markets?

Mr. KOITZ. Why don't I lay out the three plans for that time period, which is the first 10 years.

Mrs. KENNELLY. You can do that. I do congratulate you again.

Mr. KOITZ. The PSA plan cumulatively increases the borrowing from the public over 10 years, which is the cumulative effect of deficit increases, by $1.8 trillion with interest. The Ball plan cumulatively increases deficits by $.1 trillion; i.e., $100 billion over that period. The Gramlich plan improves the budget by about $250 billion over that period. So there is a wide dimension with those three plans.

Mrs. KENNELLY. Thank you, sir. I am going to ask you another hard one, but you do them very well.

We know that this is a transition problem, with many of the proposals, to move Social Security toward a more market-based system.

Could you distinguish for us between the transition related to the trust fund and the transition related to the Federal deficit?

Mr. KOITZ. OK. There are two types of transitions. One is how do you keep the Social Security system going in the context of its trust funds, making sure that there is enough credit in those trust funds to cover the benefit expenditures that the Treasury is going to have to make. The other transition is what happens to the Federal Government?

Where all three of these plans achieve solvency and, in fact, cover the transition from a Social Security standpoint, all three of them do not meet the transition from the standpoint of the overall government situation.

Mrs. KENNELLY. So we should get that information.

Mr. KOITZ. Right.

Mrs. KENNELLY. Here is my big problem with this. Since Social Security is pay-as-you-go, a person is working to pay the benefits of the people that are living right now and collecting the benefits, and working to make sure the trust funds remain solvent so he gets something down the line.

Is that at all possible when you are dealing with these kinds of numbers? It is like a double pay we see when we read it.

Mr. KOITZ. Somebody has to pay.

Mrs. KENNELLY. So I am right that there will be a period there where someone is working for present day beneficiaries and also working for their own benefit?

Mr. KOITZ. Yes, assuming you do not increase borrowing.

Mrs. KENNELLY. I know the gentleman just said we are doing it now and I know we are doing it now. But when you are starting to really put big dollars into other areas, not just the trust fund and not just the bonds, do you think this is possible?

Mr. KOITZ. I would have to say, “Show me.” We are talking about huge amounts of money here. I go back to what I started with. If you are struggling, trying to find 400 to 500 billion dollars’ worth of change to reach balance in the budget by 2002, how do you achieve something that is twice that amount, three times that amount? I do not think reverting to borrowing will do it.

Mrs. KENNELLY. Thank you very much.

Chairman BUNNING. The gentleman from Missouri, Mr. Hulshof.

Mr. HULSHOF. Thank you, Mr. Chairman.

In your testimony, I know that you did not get to the last couple of pages, which actually talk about the fact that the Advisory Council’s three proposals do not recognize or explore the full range of options, and I appreciate your responding to a question that Ms. Johnson had asked at a previous hearing.

It seems, and some argue that there are some real advantages to the alternative of reducing the cost of the current system and then carving out a piece of the existing tax rate for private accounts; in fact, some Members have introduced just that type of approach.

What are some of the advantages that you see, should Congress ultimately decide to utilize this type of approach?

Mr. KOITZ. Right off, you don't have to increase taxes. The other three plans—the three plans before you, in some way, all increase taxes, either directly through the payroll tax or through the increase in the income taxation of Social Security benefits.

I would worry, however, that the carve-out approach, as I have labeled it in my testimony, might have the same kind of negative budget effect as the 5-percent set-aside in the PSA plan. If the revenue items or spending constraints that are in this plan, not counting the set-aside, do not add up to how much you are putting into these private accounts, you are going to have a negative effect on the budget, and I think most of the five or six bills that have been recently introduced do have this problem.

Mr. HULSHOF. You also point out that the three plans, while mixing traditional Social Security benefits and private retirement savings in different ways, aim for the same level of benefits, at least as projected under our current law.

Can you give us some additional detail regarding what we need to consider as we determine what long-run level of retirement income is desirable?

Mr. KOITZ. First of all, I would say that Social Security benefits are projected to grow in real terms. Even with the transition from the normal retirement age being age 65 today up to age 67 in 2027, there will be real growth in the benefit level. There would be huge differences in terms of the financial effects, if the system were geared solely to maintaining the purchasing power of today's benefit levels.

So I think you have a range in making your value judgments, in your policy choices here about this government-run system, that span from maintaining purchasing power versus increasing the real value of the benefits.

Mr. HULSHOF. The reason I ask the question is having just come from the district when we had a 2-week, district work period, a senior came to me and actually showed me the amount of moneys that he had contributed to Social Security between the years 1937 to 1981 and how much he had put into the system and then how much money he had already taken out of the system and was angry that we were talking about maintaining the current level of benefits, which was somewhat unique to hear from someone in his capacity.

I guess as a last question, let me ask you, and I recognize that CRS is very objective, nonpartisan, not advocating a particular plan, but what are the advantages to us, Members of Congress, of acting sooner rather than later? Can you just briefly talk about the timing and the need for the reform?

Mr. KOITZ. I do not think I am out of school saying the sooner you act, the better, because the dimensions of the change can be piecemeal. They can be scaled. They can be gradual. If you wait until 2010 or 2015 and we still have a situation like is projected today, the changes, whatever they are, be they tax increases or spending constraints, would have to be very large and abrupt.

And I think the best measure of that is that if we were to finance the system solely through benefit reductions when the trust fund goes belly up in 2029, that would take a 25-percent reduction in benefit levels then.

Mr. HULSHOF. Thank you, Mr. Chairman. I yield back.

Chairman BUNNING. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Thank you very much, Mr. Koitz. I think you did a great job of framing the issue for all of us. I think that everybody understands the dilemma that the Nation confronts.

Let me bounce an issue off you that you raised when you spoke of the national savings rate. I am currently carrying, for the sixth time in 9 years, an IRA bill. This time it has 125 cosponsors in the House and 51 cosponsors in the Senate.

Do you want to speak to the advantages of incremental changes as we proceed to try to do a better job of getting people to put aside some money for their own retirement?

Mr. KOITZ. Well, I may sound like an economist, but I am not.

Mr. NEAL. Does that mean you are only going to give us one answer?

Chairman BUNNING. It is the other way around.

Mr. KOITZ. I guess I have a hard time with this one. I think the key question is substitution. If you design an IRA plan that is merely substituting for some other form of saving and it is not increasing the amount that goes into the markets that could potentially go to saving, I am not sure what you are doing, other than moving money around.

So I think the key question with any IRA change is what its net impact would be.

Mr. NEAL. But isn't part of it behavioral?

Mr. KOITZ. Yes.

Mr. NEAL. Shouldn't we be getting people to set aside some money for their own retirement, getting people to understand that there is a link to their own fate by doing a better job of determining what their own retirement is going to look like, encouraging people in their twenties, for example, in their thirties, to start to set aside some money? Do you accept the notion that we could incentivize some savings?

Mr. KOITZ. Maybe, because what you are asking them to do—what you really want them to do—is cut consumption.

Mr. NEAL. That is right.

Mr. KOITZ. And I am not going to be any more forthright than most economists. I am not sure I know how to do that.

Mr. NEAL. Thank you. Thank you for clearing that up for us.

Chairman BUNNING. We like those direct answers.

Mr. Hayworth.

Mr. HAYWORTH. I thank the Chairman and my friend from Massachusetts, and I am proud to be a cosponsor of his bill to deal with the IRA. And let us again return to this notion of savings for just a second.

You mentioned really three elements in the equation when you were first addressing the Chairman's question, and perhaps I lost you somewhere in there because, in listening to your answer, you talked about the PSA really taking 5 percent off payroll and looking at $150 to $160 billion.

Then you offered, I guess, a consensus statement from economists, thinking that really you would have the reduction in the 401(k) and that type of enforced savings.

I guess it begs the question of taking into account other forms of savings, apart from retirement plans. Right now, just generally with the Tax Code, there is a disincentive to save in traditional ways. Would it be helpful for us to lift that disincentive to save? Would that put more money into savings in general?

Mr. KOITZ. Tell me what you are doing to the Federal Government's revenue stream and then I could probably answer it. If what we are doing is losing revenue to make that incentive, I do not know where it comes out, on balance.

I have another table that I think will clarify a little bit of what I was saying earlier, if the staff could hand it out.

Mr. HAYWORTH. Great.

Mr. KOITZ. The Advisory Council report provided estimates based on the 1995 Trustees' Report of what the budget effects would be of the various plans. About 1 week ago I called the office of the actuary and asked them for how much money would go into the markets as a result of the PSA plan. That is shown in the column on the left under "money flowing into the markets, PSA contributions."

Let's pick the year 2000. The estimate was $168 billion would go into the markets from the 5-percent set-aside. The Federal borrowing that would have to take place was equal to $137 billion. And if there were no reduction in voluntary savings, you would have a net flow into the markets of $31 billion. That is scenario number one.

Under scenario number two, again picking the year 2000, I made the assumption that 30 percent of the money going into the markets, under the PSA plan, would be offset by reductions in voluntary savings, and that turned out to be $50 billion. And the net result for the year 2000 was that $19 billion would flow out of the markets.

I think that illustrates the point I was trying to make, that you have a range, depending upon a variety of assumptions, but one of them being what people do with their voluntary savings.

I would also mention that I picked the year 2000 because there is no money flowing out of the PSAs at that point to meet day-to-day consumption; but as you move out, people are going to be relying on their PSAs to live off of, in part because the Social Security benefit coming from the Government is that much smaller. I did not take that into account. But by 2020, you would start seeing some of that effect.

Mr. HAYWORTH. Thank you, sir. I have no further questions.

Chairman BUNNING. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

I am not quite sure how much of the later testimony will focus on this issue and unfortunately, some of us are going to have to be away for another meeting, including myself. So let me zero in on your charts, the budget flows, the deficit impacts.

I would ask you, you come from an analytical kind of neutral entity, so I am going to try to force you to put up the best defense against your own arguments.

Mr. KOITZ. OK.

Mr. LEVIN. Talking about the PSA plan, now tell me what you think the best, strongest argument is against the apparent impact. It increases the deficit dramatically. Your latest chart even has some analyses of savings that would indicate that there isn't going to be necessarily a huge benefit in terms of savings.

So we are trying to look at all these proposals objectively, so tell me what you think will be the best rejoinder to your analysis of the impact on deficits and the rather small potential impact on net savings.

Mr. KOITZ. You do not know that there will be a small increase in savings. That is the point.

Mr. LEVIN. But you posit a relatively small impact.

Mr. KOITZ. Under one scenario, yes.

Mr. LEVIN. So put on another hat or pretend you are writing an exam in economics and the professor says to you to put forth the best rejoinder to these materials.

Mr. KOITZ. I think there is a long-run potential savings from this kind of plan because what you are doing is leveraging. You are borrowing at a low rate and hopefully making considerably better investments with a bigger rate of return in the long run, from going into the market. I think that is principally what is going on in this plan.

The amount of borrowing is very high and it goes on for a long time, so you are asked to make a huge leap of faith that you will be able to pay this back, and more so, and that there will be a cut in consumption and increased savings in the long run.

You are also, from the other side, saying that we are going to take a big risk. And it is not, in this instance, the Social Security system that is taking the risk. If you are aiming for a given level of retirement income, because so much of that income would come from individual plans where individuals would make the choice as to how to invest, if they invested conservatively or they were unlucky, they may not get that level of retirement income that we were aiming for here in 1997.

So the risk factor on the individual, I think, is a critical factor with the PSA plan.

Mr. LEVIN. All right. I will not tell you what grade I would give that answer. I think you have tried.

I asked that because your critique, I think, has some dramatic implications for the PSA plan and I think that those who propose it have to be ready to respond to these kinds of tables.

Thank you.

Chairman BUNNING. Mr. Tanner.

Mr. TANNER. Thank you very much, Mr. Chairman. I apologize for being a few minutes late. Like everything else around here, we all have three places to be at 10 a.m., in different areas.

Thank you for your testimony. I reviewed some of the material and I just have a couple of questions.

Are you familiar or have you been made acquainted with the so-called Blue Dog proposal with respect to our budget?

Mr. KOITZ. As of the last Congress, yes.

Mr. TANNER. And what we did. Would you describe the interrelationship between the Boskin Commission's position that the CPI is overstated and the reasons contained in that document for that position and the solvency of the trust fund in the out years?

Mr. KOITZ. How big of a COLA reduction is anticipated under the Blue Dog plan right now?

Mr. TANNER. We took the Boskin Commission, which indicates the overstatement is somewhere between 0.8 and 1.6. He thought the number was 1.1. We took the low side, of course, being politically sensitive, and did a 0.8 adjustment.

In so doing, we think that that could relieve the budget by 2005 of relying on the Social Security surplus for balance and could reestablish the Social Security trust fund on its own by 2005. We also think that by doing that, you gain an additional 13 years of solvency. I would like to know your comment.

Mr. KOITZ. Well, at that order of magnitude, you are probably eliminating somewhere in excess of half of the long-run deficit. And what you would be doing—the long-run assumption is that there would be a 4 percent per year COLA throughout the 75-year projection period, and you would be talking about providing 3.2 percent per year.

I think 0.8 would give you something in the neighborhood of a 1.2 percent of payroll savings on average. The deficit is 2.19 percent of taxable payroll. So you would get somewhere near half. But as you just indicated, it does not buy you a lot of time. It buys you some more time. That 2029, if I understood you, would go out to 2042.

But I think the real pressure point comes when revenue coming into the Government is less than outgo. That happens in 2012, and if what we have done is push that out to maybe 2020 or 2022, I am not sure that that would be the only action I would want to see in a long-run Social Security plan.

Mr. TANNER. I could not agree with you more. I am just talking about—there are two problems here.

Mr. KOITZ. Right.

Mr. TANNER. Short term and long term. Perhaps a fix in the short term with, then, a followon, with some of these proposals that have been placed, the PSAs and others, would that be a reasonably sane way to go about the problem?

Mr. KOITZ. Only if the 0.8 is a good reflection of the CPI overstatement, and I am not going to jump into that swamp.

Mr. TANNER. I understand. We get much praise for our courage and little support, it seems. I think, in the interest of accuracy, if it were properly posed in that context, it seems that we all would prefer for the CPI to be as accurate as possible. People disagree with Boskin in his reasoning, I suppose, but—well, I will just leave it at that.

Thank you, Mr. Chairman.

Chairman BUNNING. I have no further questions. We want to thank you for your testimony. We appreciate your analyzing the many proposals as objectively as you have. Thank you.

Presenting the views of the GAO are Jane Ross, Director, and Frank Mulvey, Assistant Director of the Income Security Issues, Health, Education and Human Services Division.

Miss Ross, welcome back and you may proceed.

STATEMENT OF JANE L. ROSS, DIRECTOR, INCOME SECURITY ISSUES, HEALTH, EDUCATION, AND HUMAN SERVICES DIVISION, U.S. GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY FRANK MULVEY, ASSISTANT DIRECTOR, INCOME SECURITY ISSUES, HEALTH, EDUCATION, AND HUMAN SERVICES DIVISION

Ms. ROSS. Thank you, sir. Mr. Chairman, Mrs. Kennelly, Members of the Subcommittee, I am pleased to be here to discuss the impacts of proposals to address the long-term financing problems of the Social Security system, especially their effects on the financial well-being of women. I would like to talk about how and why the outcomes for women differ from those of men under the current Social Security system and under each of the three reform proposals of the Social Security Advisory Council.

One reason to be especially concerned about the financial well-being of women is that elderly, unmarried women currently have a poverty rate that is about four times that of elderly married couples.

The Social Security Act's provisions, as well as those of the three proposals, are called gender-neutral. That is, the program rules are the same for men and women. But the benefits differ because men and women differ in terms of their labor force participation, earnings levels, longevity, and the ways they invest in financial assets.

As you know, Social Security currently provides benefits based on an average of a worker's highest 35 years of earnings. Women's lower rate of labor force participation and lower earnings levels lead, on average, to lower Social Security benefits for women than for men.

For example, men currently have about 4 years of zero earnings, on average, out of the 35 years that are used in the calculation, while women average about 15 years of zero earnings out of their high 35 years. With regard to the level of earnings, the median earnings of women working year round and full time are about 70 percent that of men.

Pension benefits are also based, in various ways, on years of work and earnings levels. So, as is the case with Social Security, women retirees, on average, receive lower monthly pension benefits than men.

Social Security also provides a broad range of dependent benefits for spouses, widows, parents and children. Workers' benefits are not reduced to pay for these dependent benefits. Dependent benefits are especially important to women because two-thirds of older women are receiving some or all of their Social Security benefits based on their husband's earnings records.

Now, pensions generally don't offer the same protection to dependents as Social Security. The primary benefit for dependents in a pension system is the provision for a survivor's benefit. However, if the worker chooses this benefit, the monthly amount of the benefit is reduced in order to pay for the additional survivor protection.

At the current time, differences in longevity do not affect the receipt of monthly Social Security benefits. However, they can affect the income from pensions, which may be adjusted to reflect the number of years over which pensions will be received.

Since women live longer, their monthly pension benefits may be lower, even when their earnings were the same as men's. For men and women who are currently 65 years old, a woman can expect to live 19 years in retirement while a man can expect to live 15 years.

Further, differences in the investment behaviors of men and women do not currently affect Social Security benefits, but many defined contribution plans provide for workers to invest their assets, and differences in how men and women invest can lead to differences in their pension benefits.

When making financial decisions, women tend to be more risk-averse or conservative than men. As a result, women tend to invest more of their pension funds in safer but lower yielding assets, such as government bonds.

Consequently, a woman who contributes the same amount to her pension plan as a man may still have lower pension balances at the time of retirement because of her lower investment returns.

The three proposals of the Social Security Advisory Council make changes of varying degrees to the structure of Social Security. Many of the proposed changes will have different effects on the benefits received by men and women.

For example, extending the computation period for lifetime average earnings from 35 to 38 years, as is proposed in two of the plans, will have a greater impact on women than on men. For most women, the additional 3 years will be years with zero earnings, while for most men, the additional years will include some positive earnings.

Consequently, women will see a larger decrease in their lifetime average earnings than men, and therefore experience relatively greater reduction in their benefits.

Two of the Advisory Council plans create defined contribution accounts for workers. Since women tend to work fewer years and earn lower wages, they usually will be contributing less to their accounts.

Furthermore, even if the contributions are equal, women's more conservative investment behavior may lead to lower investment returns and lower pension benefits.

In addition, one of these plans leaves the decision about purchasing an annuity up to the individual retiree. The monthly payments to a woman will be lower than those to a man in order to offset the woman's longer life expectancy and longer period of benefit receipt. Let me just sum up.

While the proposals of the Social Security Advisory Council are intended to address the long-term financing problems, they make changes that might affect the relative level of benefits received by men and women. Narrowing the gaps in labor force attachment, earnings and investment behavior may reduce the differences in outcomes, but they are unlikely to eliminate them any time soon.

In light of this, plans to change the Social Security benefit structure should take account of their effect on the distribution of benefits between men and women, as well as for other groups.

This concludes my statement and I would be glad to answer any questions you may have.

[The prepared statement and attachments follow:]

Statement of Jane L. Ross, Director, Income Security Issues Health, Education, and Human Services Division, U.S. General Accounting Office; accompanied by Frank Mulvey, Assistant Director, Income Securities Issues Health, Education, and Human Services Divison

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss the impacts of proposals to finance and restructure the Social Security system, specifically the impacts on the financial well-being of women. As you know, the Social Security trust funds are predicted to pay out more in annual benefits than they collect in taxes beginning in 2012 and are expected to be depleted by 2029. Recently, the Social Security Advisory Council offered three alternative reform proposals to address this long-term financing problem. Each of the alternative proposals also affects the financial well-being of beneficiaries, especially women. One reason to be especially concerned about the financial well-being of women is that elderly unmarried women are much more likely to be living below the poverty line. For example, 22 percent of unmarried elderly women have income below the poverty threshold, compared with 15 percent of unmarried elderly men and only 5 percent of elderly married couples.

Today, I would like to discuss how and why the benefits for women differ from those for men under the current Social Security program and how each of the three reform proposals of the Social Security Advisory Council might particularly affect women. The information I am providing today is based on previous GAO work and contains preliminary findings from a report being prepared at the request of the Ranking Minority Member of the Subcommittee.[1]

In summary, our work shows that, despite the provisions of the Social Security Act do not differentiate between men and women, women tend to receive lower benefits than men. This is due primarily to differences in lifetime earnings because women tend to have lower wages and fewer years in the workforce. Women's experience under pension plans also differs from men's not only because of earnings differences but also because of differences in investment behavior and longevity. Moreover, public and private pension plans do not offer the same social insurance protections that Social Security does.

Furthermore, some of the provisions of the Social Security Advisory Council's three proposals may exacerbate the differences in men and women's benefits. For example, proposals that call for individual retirement accounts will pay benefits that are affected by investment behavior and longevity. Expected changes in women's labor force participation rates and increasing earnings will reduce but probably not eliminate these differences.

Demographic Characteristics and Labor Market Attachment Affect Retirement Income for Men and Women Differently

Over their lifetimes, men and women differ in many ways that have consequences for how much they will receive from Social Security and pensions. Women make up about 60 percent of the elderly population and less than half of the Social Security beneficiaries who are receiving retired worker benefits, but they account for 99 percent of those beneficiaries who receive spouse or survivor benefits. A little less than half of working women between the ages of 18 and 64 are covered by a pension plan, while slightly over half of working men are covered. The differences between men and women in pension coverage are magnified for those workers nearing retirement age—over 70 percent of men are covered compared with about 60 percent of women.

Labor Force Participation and Earnings Differ for Men and Women

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[1] Pension Plans: Survivor Benefit Coverage for Wives Increased After 1984 Pension Law (GAO/HRD–92–49, Feb. 28, 1992); Social Security: Issues Involving Benefit Equity for Working Women (GAO/HEHS–96–55, Apr. 10, 1996); and *401(k) Pension Plans: Many Take Advantage of Opportunity to Ensure Adequate Retirement Income* (GAO/HEHS–96–176, Aug. 2, 1996).

Labor force participation rates differ for men and women, with men being more likely, at any point in time, to be employed or actively seeking employment than women.[2] The gap in labor force participation rates, however, has been narrowing over time as more women enter the labor force, and the Bureau of Labor Statistics predicts it will narrow further. In 1948, for example, women's labor force participation rate was about a third of that for men, but by 1996, it was almost four-fifths of that for men. The labor force participation rate for the cohort of women currently nearing retirement age (55 to 64 years of age) was 41 percent in 1967 when they were 25 to 34 years of age. The labor force participation rate for women who are 25 to 34 years of age today is 75 percent—an increase of over 30 percentage points.

Earnings histories also affect retirement income, and women continue to earn lower wages than men. Some of this difference is due to differences in the number of hours worked, since women are more likely to work part-time and part-time workers earn lower wages. However, median earnings of women working year-round and full-time are still only about 70 percent of men's.[3]

The lower labor force participation of women leads to fewer years with covered earnings[4] on which Social Security benefits are based.[5] In 1993, the median number of years with covered earnings for men reaching 62 was 36 but was only 25 for women. Almost 60 percent of men had 35 years with covered earnings, compared with less than 20 percent of women. Lower annual earnings and fewer years with covered earnings lead to women's receiving lower monthly retired worker benefits from Social Security, since many years with low or zero earnings are used in the calculation of Social Security benefits. On average, the retired worker benefits received by women are about 75 percent of those received by men. In many cases, a woman's retired worker benefits are lower than the benefits she is eligible to receive as the spouse or survivor of a retired worker.[6]

Life Expectancies Differ for Men and Women

Women tend to live longer than men and thus may spend many of their later retirement years alone. A woman who is 65 years old can expect to live an additional 19 years (to 84 years of age), and a man of 65 can expect to live an additional 15 years (to 80 years of age). By 2070, the Social Security Administration projects that a 65-year-old woman will be able to expect to live another 22 years, and a 65-year-old-man, another 18 years. Additionally, husbands tend to be older than their wives and so are likely to die sooner. Differences in longevity do not currently affect the receipt of monthly Social Security benefits but can affect income from pensions if annuities are purchased individually.

Women Invest More Conservatively Than Men

Many pension plans give participants responsibility for managing the investment of their pension assets, and differences in how men and women invest can lead to differences in pension benefits they receive. When making financial decisions, women tend to be more risk averse than men. One consequence of this is that women tend to invest more of their pension funds in safer but lower yielding assets, such as government bonds. The results of recent study[7] of the federal Thrift Savings Plan indicate that men are much more likely to invest in the stock fund than are women. The authors estimated that, after 35 years of participation in the plan at historical yields and identical contributions, the difference in investment behavior between men and women can lead to men having a pension portfolio that is 16 percent larger.

PENSION PLAN PROVISIONS OFFER DIFFERENT BENEFITS FROM SOCIAL SECURITY

Social Security provisions and pension plan provisions differ in several ways (see app. I for a summary). Under Social Security, the basic benefit a worker receives

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[2] The labor force participation rate is the proportion of the population under consideration who are working or actively seeking employment.

[3] Even after accounting for differences in education, work effort, age, and other characteristics that affect wages, women earn wages that are about 15 to 20 percent lower than men's wages, on average.

[4] Years of covered earnings are the years in which the individual received earnings on which Social Security taxes were paid.

[5] Social Security benefits are based on the 35 years of highest covered earnings.

[6] GAO/HEHS–96–55, Apr. 10, 1996.

[7] Richard P. Hinz, David D. McCarthy, and John A. Turner, "Are Women Conservative Investors? Gender Differences in Participant Directed Pension Investments," in *Positioning Pensions for the Year 2000*, Olivia Mitchell, ed. (Philadelphia: University of Pennsylvania Press, 1996).

who retires at the normal retirement age (NRA)[8] is based on the 35 years with the highest covered earnings.[9] The formula is progressive in that it guarantees that higher-income workers receive higher benefits, while the benefits of lower-income workers are a higher percentage of their preretirement earnings. The benefit is guaranteed for the life of the retired worker and increases annually with the cost of living.

Private pensions are different. They can be classified into two basic types: defined benefit and defined contribution plans. Pension benefits in defined benefit plans are generally based on a formula that includes years with the firm, age at retirement, and salary averaged over some number of years.[10] Employers offering defined contribution plans generally promise to make guaranteed periodic contributions to workers' accounts, but the amount of retirement benefits is not specified. The benefits from defined contribution plans depend on the contributions plus investment returns or losses. Today, defined contribution plans are the most prevalent type of pension plan, and 401(k) plans are one of the fastest growing defined contribution plan types.[11] Typically, at retirement, workers receive a joint and survivor annuity that provides pension benefits to the surviving spouse after the worker's death, unless both the worker and spouse elect, in writing, not to take the joint and survivor annuity. In this instance, the retiring worker may elect, along with the spouse, to take a single life annuity or a lump-sum distribution if allowed under the plan.

When workers retire, they are uncertain how long they will live and how quickly the purchasing power of a fixed payment will deteriorate. They run the risk of outliving their assets. Annuities provide insurance against outliving assets. Some annuities provide, though at a higher cost or reduced initial benefit, insurance against inflation risk, although annuity benefits often do not keep pace with inflation. Many pension plans are managed under a group annuity contract with an insurance company that can provide lifetime benefits. Individual annuities, however, tend to be costly.

Benefits for Dependents Differ Under Social Security and Pensions

Under Social Security, the dependents of a retired worker may be eligible to receive benefits. For example, the spouse of a retired worker is eligible to receive up to 50 percent of the worker's basic benefit amount, while a dependent surviving spouse is eligible to receive up to 100 percent of the deceased worker's basic benefit. Furthermore, divorced spouses and survivors are eligible to receive benefits under a retired worker's Social Security record provided they were married for at least 10 years. If the retired worker has a child under 18 years old, the child is eligible for Social Security benefits, as is the dependent nonelderly parent of the child. The retired worker's Social Security benefit is not reduced to provide benefits to dependents and former spouses.

Pensions, both public and private, generally do not offer the same protections to dependents as Social Security. Private and public pension benefits are based on a worker's employment experience and not the size of the worker's family. At retirement, a worker and spouse normally receive a joint and survivor annuity so that the surviving spouse will continue to receive a pension benefit after the retired worker's death. A worker, with the written consent of the spouse, can elect to take retirement benefits in the form of a single life annuity so that benefits are guaranteed only for the lifetime of the retired worker.

This wasn't always the case. Under the Employee Retirement Income Security Act of 1974, a married worker had the option to choose an annuity that provided benefits only as long as the retiree lived. Recognizing marriage as an economic partnership, the Congress sought through the Retirement Equity Act of 1984 to bring the retiring worker's spouse directly into the decision-making process concerning benefit

[8] Currently, the normal retirement age is 65 years. It is set to gradually increase to 67 for those born in 1960 or after. The early retirement age (the earliest age at which a worker qualifies for Social Security retirement benefits) will remain at 62.

[9] The calculation of a worker's basic benefit amount first involves calculating average indexed monthly earnings (AIME) on the basis of the 35 years of highest earnings. For workers becoming eligible for Social Security benefits in 1997, benefits are equal to 90 percent of the first $455 of AIME, plus 32 percent of the AIME from $455 to $2,741, plus 15 percent of the AIME in excess of $2,741. The dollar amounts in the formula are called the bend points, and the percentages are called the conversion factors.

[10] In defined benefit plans that are integrated with Social Security, pension benefits also depend on the size of an individual's Social Security benefit.

[11] 401(k) pension plans are salary reduction plans that allow participants to contribute, before taxes, a portion of their salary to a retirement account. Many employers match workers' contributions to these accounts. Also, many employers allow participants to direct the investment of their account balances.

payment options. Under this act, a joint and survivor annuity became the normal payout option and written spousal consent is required to choose another option. This requirement was prompted partly by testimony before the Congress by widows who stated that they were financially unprepared at their husbands' death because they were unaware of their husbands' choice to not take a joint and survivor annuity. Through the spousal consent requirement, the Congress envisioned that, among other things, a greater percentage of married men would retain the joint and survivor annuity and give their spouses the opportunity to receive survivor benefits.

The monthly benefits under a joint and survivor annuity, however, are lower than under a single life annuity. Moreover, pension plans do not generally contain provisions to increase benefits to the retired worker for a dependent spouse or for children. As under Social Security, divorced spouses can also receive part of the retired worker's pension benefit if a qualified domestic relations order is in place. However, the retired worker's pension benefit is reduced in order to pay the former spouse.

SOME REFORM PROPOSALS WOULD MAKE SOCIAL SECURITY MORE LIKE PENSION PLANS

The three alternative proposals of the Social Security Advisory Council would make changes of varying degrees to the structure of Social Security. The key features of the proposals are summarized in appendix II.

The Maintain Benefits Plan Would Make Fewest Changes to Social Security

The Maintain Benefits (MB) plan would make only minor changes to the structure of current Social Security benefits. The major change that would affect women's benefits is the extension of the computation period for benefits from 35 years to 38 years of covered earnings.[12] Currently, earnings are averaged over the 35 years with the highest earnings to compute a worker's Social Security benefits. If the worker has worked less than 35 years, then some of the years of earnings used in the calculation are equal to zero. Extending the computation period for the lifetime average earnings to 38 years, would have a greater impact on women than on men. Although women's labor force participation is increasing, the Social Security Administration forecasts that fewer than 30 percent of the women retiring in 2020 will have 38 years of covered earnings, compared with almost 60 percent of men.

The Individual Accounts Plan Would Add a Defined Contribution Component

The Individual Accounts (IA) plan would keep many features of the current Social Security system but add an individual account modeled after the 401(k) pension plan. Workers would be required to contribute an additional 1.6 percent of taxable earnings to their individual account, which would be held by the government. Workers would direct the investment of their account balances among a limited number of investment options. At retirement, the distribution from this individual account would be converted by the government into an indexed annuity.

The IA plan, like the MB plan, would extend the computation period to 38 years; it would also change the basic benefit formula by lowering the conversion factors at the higher earnings level. This plan would also accelerate the legislated increase in the normal retirement age and then index it to future increases in longevity. As a consequence of these changes, basic Social Security benefits would be lower for all workers, but workers would also receive a monthly payment from the annuitized distribution from their individual account, which proponents claim would offset the reduction in the basic benefit.

In addition to extending the computation period, elements of the IA plan that would disproportionately affect women are the changes in benefits received by spouses and survivors, since women are much more likely to receive spouse and survivor benefits. The spouse benefit would be reduced from 50 percent of the retired worker's basic benefit amount to 33 percent. The survivor benefit would increase from 100 percent of the deceased worker's basic benefit to 75 percent of the couple's combined benefit if the latter was higher. These changes would probably result in increased lifetime benefits for many women. Additionally, at retirement a worker and spouse would receive a joint and survivor annuity for the distribution of their individual account unless the couple decided on a single life annuity.

The Personal Security Accounts Plan Would Replace Social Security With a Flat Benefit and a Defined Contribution Component

The Personal Security Account (PSA) plan would make the most dramatic changes to the structure of Social Security. This plan would replace the current system with

[12] One supporter of the MB plan does not support this provision.

a two-tier system. The tier I benefit would be a flat benefit based on years of covered earnings. The full tier I benefit, which would be equivalent to 65 percent of the poverty threshold, would be received after 35 years of covered earnings. The tier II benefit would be the distribution from the retired worker's personal security account. The personal security account is modeled after the 401(k) pension plan and would be funded by diverting 5 percentage points of the worker's Social Security payroll tax into the account,[13] which would not be held by the government. Proponents of the PSA plan claim that over a worker's lifetime the tier I benefits plus the tier II distribution would be larger than the lifetime Social Security benefits currently received by retired workers. The worker would direct the investment of his or her account assets. At retirement, workers would not be required to annuitize the distribution from their personal security account but could elect to receive a lump-sum payment. This could potentially affect women disproportionately, since the worker is not required to consult with his or her spouse regarding the disposition of the personal account distribution.

Under the PSA plan, the tier I benefit for spouses would be equal to the higher of their own tier I benefit or 50 percent of the full tier I benefit. Furthermore, spouses would receive their own tier II accumulations, if any. The tier I benefit for a survivor would be 75 percent of the benefit payable to the couple; in addition, the survivor could inherit the balance of the deceased spouse's personal security account assets.

Effects on Women's Benefits of Changing Basic Social Security Law

Many of the proposed changes to Social Security would affect the benefits received by men and by women differently.[14] The current Social Security system is comparable to a defined benefit plan's paying a guaranteed lifetime benefit that is increased with the cost of living. Each of the Advisory Council proposals would potentially change the level of that benefit, and two of the proposals would create an additional defined contribution component. Not only would retired worker benefits be changed by these proposals, but the level of benefits for spouses and survivors would be affected.

Conservative Investment Behavior May Have Adverse Consequences for Retirement Income

Two Advisory Councils plans—the IA and PSA plans—would create defined contribution accounts for workers. Both plans would also lower basic Social Security benefits. On the basis of calculations by the National Academy of Social Insurance, the IA plan would lower basic benefits by 17 percent for the average earner, while the PSA plan would lower the basic or tier I benefit to about 47 percent of the benefit paid to today's average earner. The rest of a retired worker's Social Security benefit would come from the distribution from his or her private account. Under both plans, the account balances at retirement would depend on the contributions made to the worker's account and investment returns or losses on the account assets. Since women tend to earn lower wages, they would be contributing less, on average, than men to their accounts. Furthermore, even if contributions were equal, women tend to be more conservative investors than men, which could lead to lower investment returns. Consequently, women would typically have smaller account balances at retirement and would receive lower benefits than men. The difference in investment strategy could lead to a situation in which men and women with exactly the same labor market experiences receive substantially different Social Security benefits. The extent to which investor education can close the gap in investment behavior between men and women is unknown.

How Account Distributions Are Handled Affects Benefit Levels

The two Advisory Council proposals with individual or personal accounts differ in the handling of the distribution of the account balances at retirement. The IA plan would require annuitization of the distribution at retirement, and choosing a single life annuity or a joint and survivor annuity would be left to the worker and spouse. If the single life annuity option for individual account balances was chosen, then the spouse would receive the survivor's basic benefit after the death of the retired worker plus the annuitized benefit based on the work records of both individuals.

[13] The payroll tax for Social Security is 12.4 percent of taxable earnings. The tax is split evenly between the employee and employer.

[14] The proposed changes could also affect benefits received from pension plans that are integrated with Social Security. How the changes in these benefits would affect men and women is beyond the scope of our testimony.

The PSA plan would not require that the private account distribution be annuitized at retirement. A worker and spouse could take the distribution as a lump sum and attempt to manage their funds so that they did not outlive their assets. If the assets were exhausted, the couple would have only their basic tier I benefits, plus any other savings and pension benefits. Furthermore, even if personal account tier II assets were left after the death of the retired worker, the balance of the PSA account would not necessarily have to be left to the survivor. If a worker and spouse chose to purchase an annuity at retirement, then the couple would receive a lower monthly benefit than would be available from a group annuity.

Both the IA and the PSA plans could lead to situations where men and women in identical circumstances received different Social Security benefits. Suppose a man and woman had the same labor market experiences and the same amount in their private accounts and then annuitized their distributions. The monthly annuity payments would reflect the differences in expected longevity (separate life tables could be used for men and women in the calculation of annuitized benefits) and, although the expected lifetime payments would be the same, the monthly payments to the woman would be lower, since women have longer life expectancies.

CONCLUSIONS

Even though the current provisions of Social Security are gender neutral, differences during the working and retirement years may lead to different benefits for men and women. For example, differences in labor force attachment, earnings, and longevity lead to women's being more likely than men to receive spouse or survivor benefits. Women who do receive retired worker benefits typically receive lower benefits than men. As a result of lower Social Security benefits and the lower likelihood of receiving pension benefits, among other causes, elderly single women experience much higher poverty rates than elderly married couples and elderly single men.

Social Security is a large and complex program that protects most workers and their families from income loss because of a worker's retirement. Public and private pension plans do not offer the social insurance protections that Social Security does. Pension benefits are neither increased for dependents nor generally indexed to the cost of living as are Social Security benefits. Typically, at retirement a couple will receive a joint and survivor annuity which initially pays monthly benefits that are 15 to 20 percent lower than if they chose to forgo the survivor benefits with a single life annuity. Furthermore, under a qualified domestic relations order, a divorced retired worker's pension benefits may be reduced to pay benefits to a former spouse.

While the three alternative proposals of the Social Security Advisory Council are intended to address the long-term financing problem, they would make changes that could affect the relative level of benefits received by men and women. Each of the proposals has the potential to exacerbate the current differences in benefits between men and women. Narrowing the gap in labor force attachment, earnings, and investment behavior may reduce the differences in benefits. But as long as these differences remain, men and women will continue to experience different outcomes with regard to Social Security benefits.

This concludes my prepared statement. I would be happy to answer any questions you or other Members of the Subcommittee may have. For more information on this testimony, please call Jane Ross on (202) 512–7230; Frank Mulvey, Assistant Director, on (202) 512–3592; or Thomas Hungerford, Senior Economist, on (202) 512–7028.

FEATURES OF SOCIAL SECURITY UNDER CURRENT LAW AND PENSIONS
APPENDIX I

Social Security		Current pension plan provisions		
Type of beneficiary[a]	Provisions under current law	Federal Employees' Retirement System/ Thrift Savings Plan	Defined benefit plans	Defined contribution plans
Retired worker.	Benefit computation is based on 35 years of highest covered earnings.	FERS benefit is based on statutory formula.	Benefit is based on formula under plan documents.	Benefit is based on contributions of employee, employer, or both plus investment returns of individual account balances
	Progressive formula leads to redistribution.	TSP benefit is based on employee and government contributions plus investment returns of individual account balances.		
	Benefits reduced actuarially if taken between 62 and normal retirement age (NRA); increased if taken after NRA.			
	NRA to increase to 67 years for those born after 1959.			
Spouse	Benefit is 50% of the retired worker's benefit.	(b)	(b)	(b)
	Benefit is actuarially reduced if taken between 62 and NRA.			
Survivor	Benefit is equal to amount deceased spouse would be receiving but not less than 82 ½% of deceased spouse's benefit.	Joint and survivor annuity is normal form of annuity, and survivor receives 50% of basic annuity.	Joint and survivor annuity is normal form of annuity.	Joint and survivor annuity is normal form of annuity
	Benefit is actuarially reduced if taken between 62 and NRA.			
Dually entitled beneficiary[c].	Receives own retired worker benefit plus difference (if positive) between spouse or survivor benefit and his/her retired worker benefit.	(b)	(b)	(b)

FEATURES OF SOCIAL SECURITY UNDER CURRENT LAW AND PENSIONS—CONTINUED

APPENDIX I

Social Security		Current pension plan provisions		
Type of beneficiary[a]	Provisions under current law	Federal Employees' Retirement System/ Thrift Savings Plan	Defined benefit plans	Defined contribution plans
Divorced and surviving divorced spouse.	Must have been married for at least 10 years and currently be unmarried.	Qualifying court order.	Qualified domestic relations order.	Qualified domestic relations order
	Must be at least 62 years old for divorced spouse, 60 years old for divorced survivor.			
	Benefit actuarially reduced if younger than NRA.			
	Divorced spouse benefit is 50% of retired worker's benefit.			
	Surviving divorced spouse benefit is 100% of retired worker's benefit.			
Mother or father and widowed mother or father plus child.	Have eligible child in care.	(b)	(b)	(b)
	Under 65 years old.			
	50% of retired worker's benefit plus 50% of child's benefit.			
	75% of deceased worker's benefit plus 75% of child's benefit.			

[a] Beneficiary categories are based on Social Security definitions.
[b] Not applicable.
[c] Entitled to benefit both as retired worker and as spouse or survivor of retired worker.

Features of Social Security Under Current Law and Three Reform Proposals

Appendix II

Social Security		Reform proposals of 1994–96 Social Security Advisory Council		
Type of beneficiary [a]	Provisions under current law	Maintain benefits	Individual accounts	Personal security accounts
Retired worker.	Benefit computation is based on 35 years of highest covered earnings.	Extends computation period from 35 years to 38 years of covered earnings.	Extends computation period from 35 years to 38 years of covered earnings.	Creates two-tier system with tier I a flat benefit based on years of covered earnings and tier II a personal security account (PSA) based on defined contribution pension
	Progressive formula leads to redistribution.		Changes benefit formula by lowering conversion factors.	Accelerates increase of NRA and indexes to longevity
	Benefits reduced actuarially if taken between 62 and normal retirement age (NRA); increased if taken after NRA.	Accelerates increase of NRA and indexes to longevity.	Increases early retirement age to 65 years.	
	NRA to increase to 67 years for those born after 1959.		Creates individual account (IA) based on defined contribution pension.	
Spouse	Benefit is 50% of the retired worker's benefit.	Same as current law.	Benefits are lowered from 50% to 33% of retired worker's benefit.	Benefits are tier II accumulations plus 50% full tier I benefit
	Benefit is actuarially reduced if taken between 62 and NRA.		Joint and survivor annuity with IA balance.	
Survivor	Benefit is equal to amount deceased spouse would be receiving but not less than 82 1/2% of deceased spouse's benefit.	Same as current law.	75% of couple's combined benefit.	75% of benefit payable to couple plus eligible to inherit balance of deceased spouse's PSA
	Benefit is actuarially reduced if taken between 62 and NRA.		Joint and survivor annuity with IA balance.	

FEATURES OF SOCIAL SECURITY UNDER CURRENT LAW AND THREE REFORM PROPOSALS—CONTINUED

APPENDIX II

Social Security		Reform proposals of 1994–96 Social Security Advisory Council		
Type of beneficiary [a]	Provisions under current law	Maintain benefits	Individual accounts	Personal security accounts
Dually entitled beneficiary [b].	Receives own retired worker benefit plus difference (if positive) between spouse or survivor benefit and his/her retired worker benefit.	Same as current law.	Higher of own basic benefit or 33% of spouse's benefit.	Tier II accumulations plus higher of own tier I benefit or 50% of full tier I benefit
Divorced and surviving divorced spouse.	Must have been married for at least 10 years and currently be unmarried. Must be at least 62 years old for divorced spouse, 60 years old for divorced survivor. Benefit actuarially reduced if younger than NRA. Divorced spouse benefit is 50% of retired worker's benefit. Surviving divorced spouse benefit is 100% of retired worker's benefit.	Same as current law.	No mention	No mention
Mother or father and widowed mother or father plus child.	Have eligible child in care. Under 65 years old. 50% of retired worker's benefit plus 50% of child's benefit. 75% of deceased worker's benefit plus 75% of child's benefit.	Same as current law.	Same as for spouse or survivor plus child's benefit, which is same as current law.	Same as for spouse or survivor plus child's benefit, which is same as current law

[a] Beneficiary categories are based on Social Security definitions.
[b] Entitled to benefit both as retired worker and as spouse or survivor of retired worker.

Chairman BUNNING. Thank you very much, Ms. Ross. I would like to hear your suggestions on how we can reform Social Security and restore long-term financial solvency without hurting the relative position of elderly women.

Ms. ROSS. There are four factors I talked about that make the most difference between men's and women's retirement incomes—the level of earnings, labor force participation, longevity and the differences in the ways in which men and women invest.

In two of the proposed plans more of everybody's retirement income will come from parts of the system where not only the earnings and labor force factors are at play, but the investment and longevity factors are important as well. So you are putting more retirement income into places where the potential for the men/women retirement income differential will be greater.

GAO, does not have a specific proposal. What we seek to do today is highlight the fact that when you are restructuring a system, you have to keep in mind the distribution of benefits in addition to kinds of things that Dave Koitz talked about as long as the program has a sound insurance dimension.

It is especially important to raise this issue because there is already a large group of highly vulnerable women out there—aged widows—with a very high poverty rate. I don't believe that you want to structure a system that looks fair in terms of the consistent application of the rules but could disproportionately affect a group that is already experiencing a high poverty rate.

Chairman BUNNING. So you do not have a suggestion?

Ms. ROSS. Pardon?

Chairman BUNNING. So you do not have a suggestion?

Ms. ROSS. No, I do not have a specific suggestion.

Chairman BUNNING. Let me just go over a little background, then. When Social Security began, what percentage of women were in the workforce?

Ms. ROSS. In the forties—

Chairman BUNNING. Thirties.

Ms. ROSS. It was about 30 percent.

Chairman BUNNING. Perhaps. Would you say that since we now have more women working, that this will eventually work its way out, except for the salary structures—and eventually that will work its way out, I believe, too—for female employees, rather than male employees?

Ms. ROSS. There has certainly been a huge increase in labor force participation already among women and the rate is up to about 75 percent. The estimates are that it might go as high as 80 percent. I do not think anybody anticipates that women's labor force participation will ever get to be as high as the men's rate because of other kinds of—

Chairman BUNNING. Other duties, chosen duties.

Ms. ROSS. Right. The same will likely hold true for earnings levels also. The gap seems to be narrowing, but it is not clear that the differential will go away entirely.

An important thing to keep in mind is how long the transition period is. Because the averaging period for Social Security benefits is 35 years, it will take a very long time for these improvements in women's earnings histories to be completely incorporated into the benefits contributions. So the difference could narrow, but not anytime soon.

Chairman BUNNING. I can speak for my family. I have a daughter that is 13 years older than my youngest daughter, and her participation in the workforce has been from the very first day that she graduated from college. My younger daughter's participation has been delayed just a little bit because of four children. But she is participating, but not at the same high level of salary that my oldest daughter is.

Over the long haul, that should relieve some of the problems that you are speaking about, not all of them but some of them.

Ms. ROSS. Right.

Chairman BUNNING. So we are going to have to take that into consideration when we are looking for a long-term solution, not only in benefits but in how we balance the flow of the money that is coming in.

I did not realize that women were more conservative than men in their investments. I am glad the GAO knows that because some of the daughters that I have are not more conservative than men. [Laughter.]

So I think we must include what you have suggested in any long-term solution, but there are other benefits and problems that we have to look at.

Why do you believe that women investment behavior is different than men? Do you have that as a fact?

Ms. ROSS. Part of the reason it is different is because investment behavior is affected by income and women, in general, have lower incomes. So there is some association between incomes and investment behavior. You are picking it up by gender, but it relates, at least in part, to income.

Beyond that, researchers are still trying to understand if other factors such as women being less familiar with the workings of financial markets are important. If that is the case, then, over time, women's investment strategies are likely to change as they become more familiar with the stock and bond markets. Some people are already studying whether invest or education could be helpful. In fact, we are contemplating doing a job in that area, to understand a little better whether people would have better retirement income if they had a better understanding of their investment options.

Mrs. KENNELLY. I am glad you brought that up, Mr. Chairman, because I was afraid this would begin to seem that it is a personality trait, that women are more conservative than men, and that is not the fact. The facts are exactly what Ms. Ross has been saying, that women are very, very aware that they still only earn 70 percent of income that men earn. They are very, very aware that they live longer than men live and they have to cover themselves for a certain amount of years. And they are very, very aware, if you do a study of wealth in this country, it's still, though there are many wealthy widows, there are still women, on the whole, that are much poorer than men.

So the whole issue here is not personality traits. It is that if you have less to lose, you have to be more careful about going in the market. You go into safer securities, which are obviously government securities. And we see also that you took, I think, Ms. Ross, this information from the Federal retirement investment.

Ms. ROSS. Right.

Mrs. KENNELLY. And we wish that we had a lot of wealthy government workers but usually they are the average income workers in the Government and they would love to go in the market. I cannot tell you the number of government workers, including myself, that have said, "Oh, my gosh, I wish I could have been investing the last few years," but, you never know when that bull is going to come around. If you cannot afford to lose it, don't put it in the market. This is something that we are very aware of, and women have to be cautious to take care of themselves. And we live forever.

But this is something that the Chairman and I have both discussed about the whole effort, of making sure we protect the right of women to have the choice to stay at home with their children. And yet the other side of the coin now is becoming very much forward, that so many more women, as the Chairman pointed out, work now than when the Social Security system was put into place.

To go back to your Federal thrift savings plan, my concern, Ms. Ross, and maybe you have put some time into this, my concern is if, in fact, as I said, most people cannot afford to lose their life savings and take a bet on the market, wouldn't it seem to you that if we go through this great change to personal savings accounts and go into the market and change our basic traditional Social Security system, we might find that people are taking their personal savings accounts and investing in government securities. So in other words, we have gone through this whole venture and all we have done is increase administrative costs, which are now very good, by the way, in Social Security. Have you thought about that at all?

Ms. ROSS. Well, we have certainly thought about the fact that we don't know how people will invest, but we have not done much detailed work on it yet. To the extent that many low-income people with very little investment experience will be managing their own individual retirement accounts, it is not at all clear whether they will invest in the same way as people already in the market or whether they will feel, as you have just suggested, that they have more at risk or more to lose and therefore, they will tend to be more conservative.

Mrs. KENNELLY. But I think we do know the administrative costs will definitely go up.

You mentioned the figure two-thirds of women now rely on their husband's Social Security or get their husband's Social Security.

Have you done any work to show the difference that the Chairman was talking about, that more women are working? Is that number changing? Do we have any more up-to-date information? Demographics, once again.

Ms. ROSS. What we have seen in terms of receiving Social Security benefits is that the proportion of women who get benefits on just their own work history has actually decreased some. At first this does not seem to make sense, because there are more women in the labor market. But what is happening is that the number of women who are jointly entitled—earning some benefits as a spouse and some as a worker—has grown substantially.

The proportion of women getting benefits just as retired workers has actually decreased a little bit since the sixties as the proportion receiving dually entitled benefits has grown.

Mrs. KENNELLY. And if you are a couple with no children and you have both worked through your entire relationship, often from young people to your retirement, and you are a couple, the husband working, the wife never working, and she is getting more, this is the thing we are going to have to wrestle with. Should we address that particular situation?

Ms. ROSS. We did some work last year on this issue of equity in Social Security. When the Social Security system was designed, in the thirties, the model family was the male worker and his wife at home. Because those who designed the system had concerns about income adequacy, as well as fairness, there was a set of dependents' benefits that were added. These are the kind of changes that made Social Security a social insurance system.

Over time, as more women have entered the labor market, so they are also eligible for workers' benefits. This has created some tension and led some women to question how come they have to pay Social Security tax? They go to work, pay Social Security taxes and end up with a benefit that is not any larger than their neighbor's, who stayed home.

Mrs. KENNELLY. That is what I hear all the time.

Ms. ROSS. So as the demographics are changing, the model on which Social Security was based, may need to be reexamined. In any case, there is certainly a tension that has developed between the fairness and adequacy goals that were built in at the beginning.

Mrs. KENNELLY. In your work did you see any concern that as you look at some of these proposals, they are more like a defined contribution plan than a defined benefit plan? Does that concern you, that individuals will have their own personal savings account and your widow might end up with a real problem here?

Ms. ROSS. Well, having more of your retirement income in some sort of a equities-market-related account exacerbates the problems we talked about before, such as the greater longevity of women. If they decide to buy a life annuity, it has to last longer than for a man and therefore, it will cost more.

Mrs. KENNELLY. Some of the reform plans are not even requiring annuities.

Ms. ROSS. But then if the annuity is not mandatory and a female retiree decides she wants to purchase it privately, because she wants to make sure she doesn't outlive her income, she will get a lower monthly benefit, because an insurance company or an annuity provider will take account of the fact that she has a longer life expectancy. In other words, not everybody uses unisex tables to decide on the amount of an annuity——

Mrs. KENNELLY. The way some of these plans are written, she might never have anything, if you really get down to it. You are in the market now and you have a plan and your husband is putting into it, and we have all the problems we have had with pensions, about signing away rights and all the rest.

I am glad you are here because we are feeling our way and there are a lot of unanswered questions that we have to answer. It is going to take a lot of work and we will be talking.

Thank you very much.

Chairman BUNNING. Ken.

Mr. HULSHOF. Thank you, Mr. Chairman.

Ms. Ross, you mentioned the four disparate factors—level of earnings, longevity. Personally, I can tell you that I would be interested in legislation that would reduce the disparity in longevity, but I am not quite sure——

Ms. ROSS. I hope you would want to increase the life expectancy of men and not the other way around.

Mr. HULSHOF. And I am not sure this Subcommittee has jurisdiction over that matter.

My wife, Ms. Ross, is a professional. I am proud of the career that she is pursuing. She shares my conservative philosophies except when it comes to investments. Boy, what a roller-coaster ride. She takes care of those investments.

You mentioned briefly education—do you think that there is a role for investor education that might help narrow these future differences in men's and women's investment patterns?

Ms. ROSS. There has been a limited amount of study that suggests that education can make some difference, but we plan to take a more thorough look at the role of investor education.

Mr. HULSHOF. I appreciate, the study that Messrs. Hinz, McCarthy and Turner did regarding this pattern, and let me put you on the spot a little bit if you are not intimately familiar with that study.

Did they just look more at an historical perspective? As the chairman was asking you questions, going back well into the forties, or do they anticipate or, in the study, did they see perhaps a more aggressive investment strategy, as women become more mobile and pursuing more vigorous careers?

Ms. ROSS. Their study was based on fairly recent data from the thrift savings plan. So it does not have that historical perspective or a projection.

Mr. HULSHOF. OK. That is all. Thanks.

Chairman BUNNING. Mr. Collins, do you care to question?

Mr. COLLINS. Mr. Chairman, I regret that I missed Miss Ross's testimony. I am just picking up on bits and pieces in reviewing some of the comments.

But, the pattern that I sense that you are referring to is the proposals would create a possible further discrepancy in earnings, but will that change? We are talking about the past but we are also talking about the future, too. Is that going to change in the future with the fact that more women now are beginning to enter into professional fields and are earning more income and investments change and differ from what they have been in the past?

Will not just the system itself and society make a change within itself?

Ms. ROSS. I think you know we have already been seeing that kind of change occur as women are becoming more active in the workforce, and the change has been to the point now where about 75 percent of women are active in the labor force. However, there are still many more women than men that have many years with zero earnings, and the expectation is that will continue.

So things should get better in the future for women relative to men, with regard to their labor force participation and their earnings, but it is doubtful that the differences will be eliminated. Certainly, they will not be eliminated quickly because the averaging period for Social Security benefits is 35 years. So it will take a while before changes that are going on now for young women in their twenties and thirties are actually reflected in greater parity on retirement income.

So it still seems is something to pay particular attention to as the Congress assesses the Social Security reform options.

Mr. COLLINS. I think that is true. Of course, a lot of this just did not happen overnight. For some families, employment is a matter of choice as to whether or not they work. But for many more really it is not a choice of whether or not to work; it is a matter of fact that they need the additional income to help with their lifestyle, to maintain a lifestyle and meet the needs of their family.

And a lot of that has been caused by actions of government over the years that have now taken about 40 percent of the family income, or closer to 50 percent when you get all taxation involved, in income. So a family has to work half a year just to meet the tax obligations of their earnings. That forces a lot of women to work who would have rather had the choice of staying home.

I do not know if there is an answer. I understand that you did not have a proposal, per se, to address this problem, because I do not know if there is a proposal out there that will address that problem, whether it is a matter of choice in the marketplace and some decisions in many other areas that the Congress will be making over the next years to change the policy of taxation and such that will, in itself, drive change.

Ms. ROSS. I think the primary message we were trying to convey in our testimony today was that at the current time and for quite some time into the future, there will be differences between men and women in terms of things that relate to their Social Security benefits. And, as you are thinking about restructuring the system, along with all of the other things you have to keep in mind, it seems appropriate to consider how a particular set of rules affects different groups, such as men and women differently. As long as Social Security continues to have a social insurance dimension, the different impact on low-and high-income workers also will need to be considered.

Mr. COLLINS. And I agree, you do not want to look at and adopt proposals that will create an even further discrepancy, even unintentionally.

Thank you, Mr. Chairman.

Chairman BUNNING. I have one last question and I do not know if you have the answer. How many people receiving Social Security depend on that payment as their main source of income?

Ms. ROSS. Sixty percent of them depend on Social Security for more than half of their income.

Chairman BUNNING. Sixty percent rely on the Social Security benefit payment for more than half their income. Thank you. Thank you for your testimony.

We will take a break. We will be right back. We have a vote on the floor. If the next panel would move up to the table, we would appreciate that, and we will be back as soon as we can. We are in recess.

[Recess.]

Chairman BUNNING. If the panel would please be seated, we will get back to our testimony.

We conclude with a panel of individual experts: Dr. Stuart Butler, vice president of Domestic Policy Studies at the Heritage Foundation; Dr. Jerry Mashaw from Yale University's Institute of Social and Policy Studies where he is a Sterling Professor of Law and Professor of Management; C. Eugene Steuerle, a senior fellow at the Urban Institute; and an old, familiar face, Dr. Robert Myers, former Chief Actuary and Deputy Commissioner at the Social Security Administration and former Executive Director of the National Commission on Social Security Reform.

Dr. Butler, go right ahead.

STATEMENT OF STUART BUTLER, PH.D., VICE PRESIDENT, DOMESTIC POLICY STUDIES, HERITAGE FOUNDATION

Mr. BUTLER. Mr. Chairman, most of the focus up till now in the hearings has been on the larger macroeconomic issues, such as savings rates. I want to focus a little bit more on the aspects of any framework of evaluation with regard to workers and future beneficiaries as individuals, or how they would see these different reform. In other words, I will preserve a kind of consumer's checklist that you might want to apply to rival proposals. I touch on a number of them in my testimony and I just want to focus on three in the short time I have.

The first is: "Does the proposal significantly improve the rate of return on the contributions made by today's workers?" If you net out from the contributions that workers make the spousal benefits, the disability benefits and so on, and just focus on the contributions towards retirement income, a male worker of average wages born after 1951 will actually lose money in real terms with regard to their payments. And when you look at certain categories of individuals, like minority workers, it is even worse than that.

So when one is looking at different proposals, one of the criterion has got to be how does it affect the rate of return. When you look at things like raising the retirement age, for example, or increasing payroll taxes, clearly that is going to reduce the rate of return.

The second criterion I think it is important to apply from the consumer's point of view is: "Would the proposal actually provide workers with a clear statement of what the actual returns are in the alternative proposals and the existing system?" This is a very real concern to people. When you are looking at, say, a wife who is considering going back into the workforce and has an option to do that in order to partly help fund their retirement through Social Security. Maybe the other option is to stay at home and have the husband work more overtime and put some money into a savings plan for the wife. The comparisons are very real that have to be taken into account.

But today the SSA benefit statements, as you well know from the GAO reports, are very ineffective in providing that kind of information and also are very unclear.

So it seems to me that one of the important steps that should be in any reform is a much clearer statement so that people can make real decisions about their retirement, by actually knowing the effective rate of return that they would get on their current Social Security benefits and contributions.

The third criterion I think that should be in play is: "Does the reform provide alternatives to an annuity-type retirement income system?" An annuity is not always the best retirement vehicle for individuals. It is different for different individuals, as you well know. People who have a low life expectancy in general are not going to find an annuity the most attractive way of savings. If people want to have a nest egg for their spouse, to supplement spousal benefits, or for their children, some kind of savings plan, as opposed to an annuity. For somebody with a low life expectancy it makes a lot of sense. There are various other reasons why an annuity would not be attractive.

So when one is looking at alternative reforms, the extent to which they allow alternatives to an annuity-based system is very important and should be clear and should be one criterion.

The last criterion I will just mention, which is particularly applicable to any kind of opt-out approach or personal savings account approach, is the extent to which the reform provides a down side risk protection, an issue which has been raised, by previous witnesses. You can have people losing their shirt in a bull market and it is very important to look carefully at what kinds of risk protections are placed in any proposal that allows people to opt out of the current system.

There are many ways in which one might do this: Certain requirements on the portfolio itself to spread risk. Possibly a requirement that a private plan actually guarantees the same rates of return, or at least includes an annuity equivalent to Social Security today, would be one way to go, or is structured similarly to Social Security today. In the United Kingdom, which is a partly privatized system, that is one of the requirements on their plans.

So I think it is very important, when you look at these issues, to consider the consumer, the worker himself, and the way he or she would see the alternatives. This must be taken into account, besides the bigger issues associated with the trust fund and the savings rate.

[The prepared statement and attachments follow:]

Statement of Stuart Butler, Ph.D., Vice President, Domestic Policy Studies, Heritage Foundation

My name is Stuart Butler. I am Vice President of Domestic and Economic Policy Studies at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

I appreciate the opportunity to testify on a framework for evaluating Social Security reform proposals. While others no doubt will address this by focusing on the larger macroeconomic or public finance issues associated with reform, I will focus my testimony on the issues that would directly effect workers and future beneficiaries. The main reason we are able to discuss reform of the Social Security system today—even radical reform—is because an increasing proportion of younger workers has come to believe that Social Security is no longer a retirement income security system for them. These Americans are concerned that any reform of the Social Security system should result in a better and more secure retirement income system. Thus quite apart from the macroeconomic issues involved in the Social Security debate, any reform must address directly the individual retirement needs of working Americans.

With this in mind, I would urge the subcommittee and Congress to include the following criteria in a framework for evaluating reforms.

(1) Does the proposal significantly improve the rate of return on a worker's contributions to the retirement system?

Today's Social Security system provides very poor returns to most workers for the investment they make in payroll taxes. The younger a worker is, generally the lower will be the rate of return. The attached charts have been assembled using the Social Security Administration's benefits software. The calculations compare the typical inflation-adjusted retirement income for these workers with the estimated share of the employer and employee payroll taxes dedicated to pension benefits. As the chart for male workers of average earnings (as defined by the Social Security Administration) indicates, the rate of return is low for workers of any age, but for workers born after 1951 it is actually negative. The current SSA average wage is $24,799. Thus in real terms the Social Security system for these latter workers actually reduces the real value of the money put aside for retirement. For low income male workers the picture is only slightly better, as it is for female workers in general, but all young workers face very low or negative returns on their mandatory savings.

For a reform to win support among younger workers it must improve the rate of return. That criterion necessarily raises a problem for at least three categories of reform: raising the retirement age; reducing or taxing more heavily expected benefits, and raising payroll taxes. Each of these would have the effect of reducing the rate of return.

As an example, consider what the rate of return would be for a typical worker if the retirement age today were raised immediately to 70 rather than 65. This would increase the period during which payroll taxes were paid, for current workers, and reduce the period during which benefits were received, thereby reducing the rate of return. As the accompanying chart shows, for the average worker (i.e. "combined" male and female) earning the SSA average wage, this step would mean that workers born between 1937 and 1975 (the current "break even" point for all average workers) would face negative returns rather than positive returns. For a worker born in 1956, for instance, the rate of return would fall from about 0.5 percent to about minus 1.5 percent.

(2) Would Social Security under the proposal provide workers with a clear statement of the return on contributions?

When President Roosevelt launched the Social Security system, he emphasized that it should be seen as but one leg of a three-legged stool, the other two legs being individual savings for retirement and employment-based pension plans. With these three legs to the retirement pension stool, couples could plan how best to allocate their savings to strike the proper balance between using their earnings to fund expenses during their working life and setting aside money to help fund their retirement years.

Today there is a rich variety of savings tools for retirement, complementing Social Security. Not only are there many savings vehicles, such as Individual Retirement Accounts, 401 (k) plans, and many employer-sponsored pension plans, but the methods of providing income vary, including annuities, whole life insurance programs, and lump-sum savings plans.

To determine the array of retirement plans that make most sense to a couple or individual, one of the crucial pieces of information needed is an estimate of the rate of return from contributions to a retirement plan. Thus for Americans to judge if and how they should supplement their expected Social Security benefits, they need a clear indication of the return they can expect from their contributions to Social Security. Even more important, in the context of evaluating proposed Social Security reforms, they must have a clear idea how a reform might affect the rate of return on the various contributions they make, in payroll taxes, IRA contributions, etc. Without this, Americans will be unable to determine whether a reform will or will not enhance their retirement security.

At the end of last year, the Chairman of this subcommittee received a report from the General Accounting Office indicating that the estimated benefit statements currently provided by the Social Security Administration, though well-received, were difficult for Americans to understand.[1] The GAO recommended a number of changes to make the Personal Earnings and Benefit Estimate Statement (PEBES)—soon to be distributed to all workers—easier to navigate and understand. One crucial element in any statement, however, must be an estimate of the rate of return on Social Security contributions. This is particularly important in any reform that includes an "opt-out" provision. Reforms that would allow workers to divert some of their So-

[1] SSA Benefit Statements GAO/HEHS–97–19, December 1996.

cial Security taxes into a private retirement plan must permit workers to make some comparison between Social Security and private alternatives—otherwise decisions will tend to be made on the basis of guesses and prevailing wisdom rather than real, individualized information.

Even before any general reform of Social Security, Congress should take action to improve the PEBES statements that will over the next few years be mailed to over 100 million Americans annually. In addition to the improvements in presentation recommended by the GAO, Congress should require the SSA to include a real rate of return estimate. Legislation to require this is currently being prepared by Senator Rod Grams (R–MN). I would urge the subcommittee to examine that legislation.

(3) DOES THE PROPOSAL ALLOW WORKERS, ESPECIALLY THOSE WITH LOWER LIFE EXPECTANCIES, TO CHOOSE AN ALTERNATIVE TO AN ANNUITY SYSTEM?

Payroll tax contributions to Social Security are based on wage and salary earnings, but the total retirement payout from Social Security depends on life expectancy. This is the characteristic feature of an annuity, which is the central retirement income product contained in Social Security (Social Security does, of course, also transfer wealth through social insurance, and provides benefits other than retirement income).

Any financial planner would point out to a prospective client, however, that an annuity (or at least complete dependence on an annuity) is not necessarily the most prudent way to assure retirement security. This is particularly the case for an individual with a low expectancy compared with others of the same age and income. In those cases it might make far more sense to set aside most contributions into a traditional savings plan, perhaps supplemented with life insurance and a modest annuity. In this way the individual would have a potentially large sum with which to enjoy what would likely be a relatively short retirement, or a larger estate to pass onto his or her heirs.

The "annuity-only" nature of Social Security denies workers the flexibility to improve the security of their retirement years by choosing to place some of their payroll tax contributions into some vehicle other than an annuity. This is a serious shortcoming of Social Security today for some whole classes of Americans with shorter life expectancies, such as African-American males (who encounter among the lowest rates of return from the current system).

Moreover, for many low-income workers, Social Security constitutes virtually he only method of "saving" for retirement available to them, since after Social Security taxes they have insufficient discretionary income to permit significant savings. Thus a system which essentially diverts earnings into an annuity system also depletes the potential for private savings.

One criterion that should be applied to the evaluation of any reform plan is whether it corrects this inherent problem. This might be accomplished within he current structure by introducing a range of products and permitting individuals to make choices at various points during their working life. Opt-out proposals would accomplish the objective by allowing workers to dedicate part of their payroll taxes to a non-annuity retirement plan if they wished. Proposals that only change the tax and benefit amounts would not deal with this concern.

(4) DOES AN "OPT OUT" OR "PRIVATIZATION" PROPOSAL INCLUDE DOWNSIDE RISK PROTECTION?

A number of reform proposals would allow workers to devote some portion of their current payroll taxes, or require them to devote a supplementary payroll tax, into a private retirement plan.

Given the estimated rate of returns for today's younger workers under Social Security, the typical likely returns from even the most conservative private savings or investment vehicles would be far higher. However, these private returns are subject to two significant forms of risk. The first is the inherent risk associated with any specific investment in the private economy -even when stocks are rising rapidly, individual investors in particular stocks may be losing their shirts. The second is the risk associated with the financial stability of any intermediary institution controlling an investor's funds.

These are not risks associated with the current Social Security system. However, if the government were to invest a portion of Social Security payroll tax receipts in the stock market, workers would face the risk that these funds might be badly invested—perhaps forcing future benefits reductions. Moreover, since benefits are effectively set by Congress, not by returns from the market, there is a "political" risk inherent in Social Security.

One criterion for evaluating reform proposals should be the degree to which the proposal includes downside risk protection, if at all. This is particularly an issue with opt-out proposals. One way a degree of protection could be included would be a requirement that at least some portion of contributions to be retained in a government-sponsored "safety-net" pension. An alternative, or supplement, to this would be some requirements on the investments that could be made under the private option, such as a rule that some portion be invested in Treasury bills or other relatively safe vehicles. There could even be a rule that a private plan must provide a structure and level of benefits at least comparable to the existing Social Security program. The British partly-privatized system, for instance, requires private plans to assure at least comparable benefits. A rule might even require a private plan to include an annuity identical to the estimated benefits from Social Security if the worker had chosen to remain entirely in that system.

The solvency risk associated with private plans could still remain even with these requirements. Thus Congress also should evaluate the steps contained in a proposal to protect workers and beneficiaries from the insolvency of financial intermediaries handling their funds. These steps might include solvency requirements for each intermediary, a requirement that an intermediary acquire secondary insurance to spread the risk, or a government insurance backstop.

(5) DOES AN "OPT OUT" OR "PRIVATIZATION" PROPOSAL PROTECT WORKERS FROM FRAUDULENT, MISLEADING OR UNSOUND PLANS?

Another concern about privatization proposals is that workers might make unwise decisions because of misleading (intentional or unintentional) or fraudulent marketing. This is a common concern raised whenever Americans are allowed to make important choices, and often is exaggerated. Nevertheless, experience suggests that there are significant dangers to avoid and proposals should indicate how they address them. For example, the aggressive marketing of supplementary health insurance ("Medigap") policies to seniors some years ago resulted in many elderly Americans buying several plans with overlapping coverage. And in the early years of Britain's Social Security opt-out program, there were sufficiently widespread cases of misrepresentation that Parliament took action.

Proposals might include a variety of ways to reduce the concern to acceptable levels. Standardized marketing requirements is one common approach. These rules would require plans to present certain information in a standardized way, so that comparisons can easily be made.

(6) DOES THE PROPOSAL PROTECT EXISTING BENEFICIARIES?

While the focus of most reform proposals is on future beneficiaries, just as important—especially from a political point of view—is how a reform would affect Americans who are already retired or may be so close to retirement that they could do little to accommodate to the change before retiring. These Americans are concerned in two general ways.

First, would the proposed reform protect and improve the condition of the trust fund from which their benefits are paid? The pay-as-you-go nature of the current system makes this issue particularly acute. Increases in the payroll tax would add revenues and thus raise the level of protection, although this would also reduce the rate of return and have other disturbing side-effects. Opt-out proposals would reduce the revenue available to pay current beneficiaries, even though these proposals would reduce the long-term liabilities of the Social Security system. This latter group of proposals needs to be examined to see if the revenues are sufficient during the transitional period, before liabilities fall.

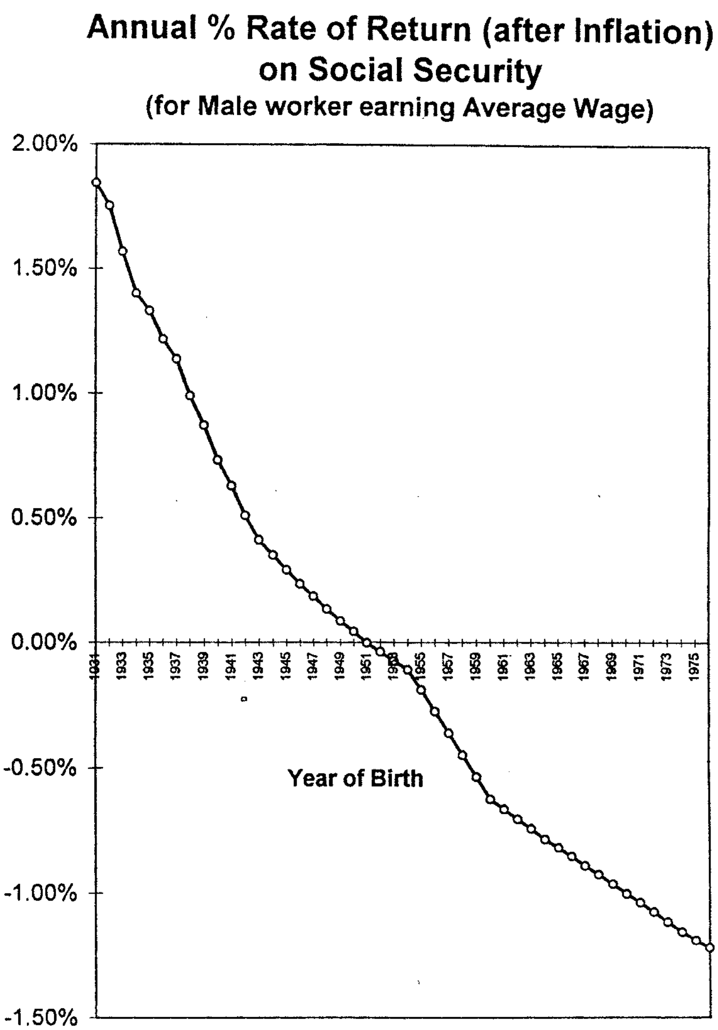
Second, what assurance does the proposal give retirees that future benefits are secure? Current beneficiaries understandably are concerned about the level and certainly of their future benefits. A criterion for evaluation should be the degree to which the proposal guarantees a specific real level of benefits, either as the total benefit or as a minimum. For example, some reformers propose converting the existing stream of Social Security benefits into a form of Treasury bond with an indexed interest payout, so that Congress could not change future benefits.

TECHNICAL NOTE

The annual rate of return to Social Security is computed by estimating the lifetime OASI taxes which the average individual can expect to pay and the lifetime OAS benefits which they can expect to collect. Each individual is assumed to earn the average annual age in each year between age 20 and retirement. They are then assumed to collect the corresponding OAS benefit in each year between their retirement and the year in which their life expectancy ends.

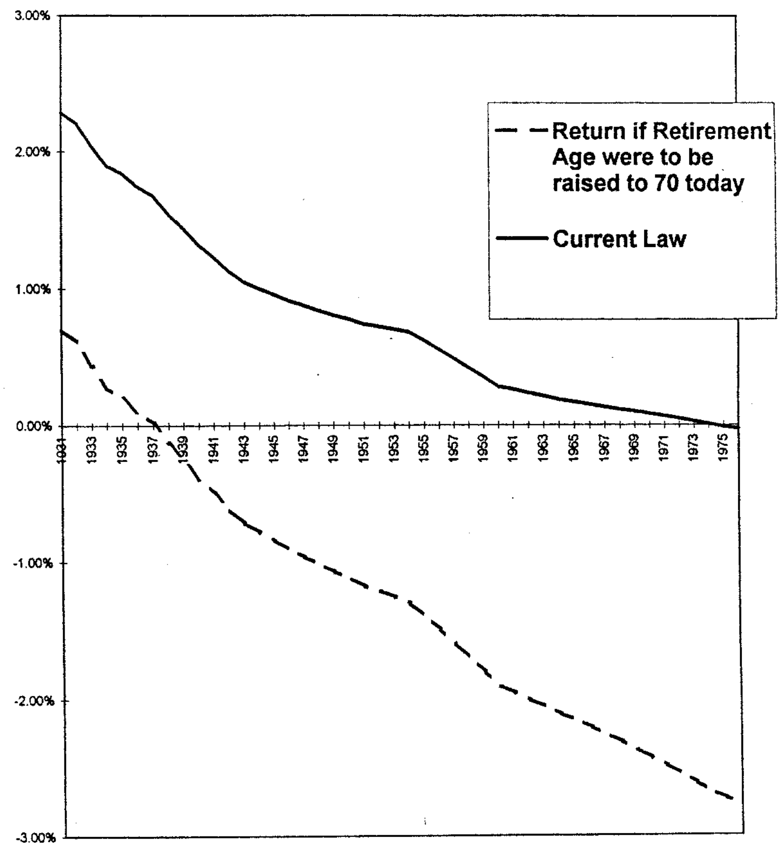
The annual rate of return is calculated as for a private investment plan. OAS taxes are treated as negative cash flows (i.e. as initial investments) and OAS benefits are treated as positive cash flows (i.e. the return these investments). The rate of return is the value of the annual compound interest rate on the individual's "initial investments" through their working lifetime which will enable them to receive a sum equivalent to that which they can expect to receive in social security benefits. For example a 1 percent rate of return means that an individual will receive back from Social Security an amount equivalent to that which they would have received had they invested their OAS taxes and earned a compound annual rate of 1 percent. A rate of return of minus 1 percent means that the individual will receive back from the OAS program an amount equivalent to that which they would have received had they invested their taxes and say the value of their investment shrink at a compound rate of 1% per annum. The rates of return calculated refer to the "real" (or post-inflation) rate of return and are estimated on the basis of inflation-adjusted 1994 dollars.

For the years 1931–94, historical data on wages and OAS tax schedules from the Social Security Administration's 1996 "Annual Statistical Supplement to the Social Security Bulletin" are used to calculate OAS tax payments for the typical individual. For the post-1994 period, the mid-range estimates from the 1996 Annual Report of the Board of Trustees of the OASI, DI and SMI Trust Funds (which represent the Social Security Administration's "best guess" about future economic and demographic conditions) are used to project future wages, inflation rates, taxes and life expectancy. The Social Security Administration's own PEBES computer program, which is identical to that in use in SSA field offices, is used to calculate the annual value of OAS retirement benefits. The future OAS tax schedule is assumed to be equal to that mandated by current law.



Source: Heritage calculations based on mid-range assumptions from the1996 Annual Report of the Board of Trustees of the Social Security Trust Funds. Projections are based on rate and benefit structure contained in current law.

Annual % Rate of Return (after Inflation) on Social Security
(for Worker earning Average Wage)



Source: Heritage calculations based on mid-range assumptions from the 1996 Report of the Board of Trustees of the Social Security Trust Funds.

Chairman BUNNING. Dr. Mashaw.

STATEMENT OF JERRY L. MASHAW, PH.D., STERLING PROFESSOR OF LAW, PROFESSOR OF PUBLIC MANAGEMENT; AND PROFESSOR AT INSTITUTE OF SOCIAL AND POLICY STUDIES, YALE UNIVERSITY

Mr. MASHAW. Thank you, Mr. Chairman. Let me very briefly talk about a couple of major points that I think ought to be considered as we think about the future of Social Security.

I think what we ought to think about primarily is the important values that Social Security currently serves. The first is income security for workers against loss of wage support by death, disability or insufficient wealth to finance a decent retirement. The second is fairness in the distribution of benefits and burdens in the overall retirement system, by which I mean not only Social Security but also the tax expenditures that go into 401(k) plans, IRAs, mortgage deductions and the like.

I think the current Social Security system gets fairly high scores in relation to both of these values. It pools risks of having relatively low lifetime earnings. We know that it reduces poverty enormously among the elderly. The average wage earner actually has a relatively low wage by the standards of most people sitting in this room. And one third of those paying FICA taxes have earnings that are $9,000 in 1993 dollars.

So we are talking about protecting a lot of people who cannot easily bear market risk on their own. Those market risks include not just being a low-wage earner over your lifetime but also the market risk of what happens to your savings in an up-and-down stock market.

Finally, the Social Security system has substantially higher ratios of payments for lower contributors, offsetting major benefits to higher wage earners elsewhere.

The proposals to shift the program into a more private-like market format, do not score very well in relation to these basic values. They reduce the redistribution that goes on in the system and, to that extent, they have very serious effects on low-wage workers or those who might become disabled before retirement. And second, market risk bearing by low-wage workers is not a very good idea. They are not able to bear those risks.

The basic idea in privatizing accounts is to attempt to get the security of mandated savings and, at the same time, the gains from prudent investment in market accounts. The problem is that we may not get those values. What we may get is the insecurity of market risk bearing, combined with resentment of government regulation of what people can do with something which is supposed to be their own account.

I am reminded of the story of George Bernard Shaw, who was approached by an actress who suggested that they get married because with her good looks and his brains, they would have wonderful children. He suggested to her, “Madam, it is just possible that they would get your brains and my looks.” That is the sort of possibility we should be concerned about with mandated private accounts.

Maintaining a publicly owned and administered system does not affect "the moneys worth" of pensions to individuals. This is not rocket science. It depends on the amount invested, the interest rate, and the time at which something is invested, and the expenses of administering the program. A publicly financed and publicly managed can be designed to program have exactly the same returns to retirees as a private one.

We have already talked this morning about the uncertainties inherent in the net national savings issue. There are certain things, I think, that are relatively predictable. Some investment in the equities market, in a public account or in a private account—it does not matter—will have some positive impact on net national savings. If everything else stays the same, smaller amounts of taxes will have to be levied to pay benefits. Some portion of those taxes not collected will be consumed; some will be saved. There this will be some small increase in net national savings.

Beyond that, I think we cannot say anything because the behavioral effects are too unpredictable.

Let's illustrate this point by recounting a story. Martin Feldstein, a very distinguished economist, is also well known for predicting very large dissavings effects from the Social Security system. Mr. Feldstein premises that funding on the belief that workers looking at the possibility of getting this income stream limit the amount of savings they engage in.

I am told that Professor Marty Feldstein, when he was being confirmed to be chairman of the Council of Economic Advisors, had to fill out the usual forms. When filling out his financial forms, he failed to include a large financial asset, his TIAA–CREF retirement fund.

If Martin Feldstein can forget about his TIAA–CREF retirement fund when listing his net assets, one wonders how much workers think about either their Social Security benefits or the value of their IRAs. I would not predict anything on the basis of what we know about what workers think. Thank you.

[The prepared statement follows:]

Statement of Jerry L. Mashaw, Ph.D., Sterling Professor of Law, Professor of Public Management; and Professor at Institute of Social and Policy Studies, Yale University

Projections of the Social Security system's capacity to meet future pension obligations suggest two things: First, there is no crisis. The system is fully financed for the next three decades. Second, changes are necessary to assure financial soundness of the system into the indefinite future. But, if actions are taken relatively quickly, modest adjustments in tax rates and benefit levels are all that are necessary. The Trustees' "best estimate" of the long-term "deficit" pegs it at 2.19% of payroll.

A collection of modest changes, agreed to by most members of the 1994–96 Advisory Council on Social Security (ACSS), reduce this projected long-term deficit by half. Expressed as a % of payroll, these changes produce the following effects:

- extend coverage to newly hired State and local employees (.22%);
- CPI corrections already made by the BLS (.31%);
- increase the benefit computation period from 35 to 38 years (.28%); and
- tax benefits like other defined-benefit pensions (.31%).

The remaining gap could be closed by a small FICA tax increase (.55% each on employers and employees).

While these adjustments are not noncontroversial, they are clearly doable. This leads to an obvious question about the current debate concerning Social Security pensions. Why are many people, including some of the ACSS members, suggesting significant changes in the form of Social Security pensions? And, what do they and others mean when they suggest that Social Security should somehow be "privatized"?

As Congress considers how to adjust the Social Security program, it is critical to understand what visions of Social Security's future underlie various proposals and why those proposals are being offered. To simplify matters I will confine my remarks to the three proposals recently advanced by the ACSS.

VARIETIES OF PRIVATIZATION

The current Social Security system is a "public system" in virtually every relevant sense. Public decisions determine the level of taxation and the benefit structure as well as how reserve funds are invested. Reserves are invested only in public bonds (designated Treasury securities). Risks are publicly borne through universal pooling arrangements. Ownership of funds prior to payment of retirement benefits is in public hands, and the relationship of contributors and beneficiaries to the pension system is governed largely by public law.

Privatizing Social Security pensions could, therefore, mean a number of very different things. We might be asking whether the funding of the Social Security system should include the investment of Social Security reserves in private markets. We might be asking, in addition, whether some portion of mandatory retirement accounts should be individually owned and held at individual market risk. We might be asking further whether mandated individual accounts should devolve investment decision making onto individuals both during the accumulation period and at the time of distribution.

These are in effect the three very different questions asked and answered by the proposals of the 1996–97 Advisory Council on Social Security. It is crucial to recognize that the ACSS proposals differ because they address different issues, not because the members disagreed about what method would solve the long-term finance question. All the proposals solve the projected, long-term fiscal issues facing the Social Security system. They are in that sense, fiscally equivalent. The interesting distinctions among the proposals lie along three very different dimensions—their political premises, their effects on workers' retirement security and their effects on the distributional fairness of our overall retirement security policies.

POLICY BASES FOR PARTIAL PRIVATIZATION

The proposal to invest a portion of Social Security reserves in private equity markets (the so-called "Maintain Benefits" or "MB" plan) begins with a political judgment that something very like the current system is desirable. Social Security now contains a complex compromise between pension adequacy (the provision of a base line pension that provides a reasonable base of income security for the average worker) and equity (the provision of income security that is tied to prior contributions). The MB proposal makes virtually no change in this balance and retains a public promise of a specified level of support in retirement. The tentative proposal in the MB plan to invest Social Security reserves partially in the equities market is addressed to the limited and straightforward question of how best to finance the current system over time. It seeks to establish fiscal balance, without any tax increases for nearly four decades, by harnessing the returns on a portion of the Social Security Trust Fund's reserves to the overall productivity of the American economy.

The proposal to create individual retirement accounts asks and answers two rather different questions. On one view it asks only a strategic question of how contributions to Social Security retirement income can be increased in a fashion that is politically acceptable. From this standpoint the "Individual Account" (IA) proposal is committed to the current system, but believes that its preservation is best accomplished by an immediate tax increase disguised as an individually owned retirement account. Because the amount of the increased contributions are small, and only that increase is included in the individual account, the alteration of the current system could be viewed as modest.

On another, and I believe more persuasive, view, the individual account model makes important political breaks with past arrangements. We have, after all, never before included mandated savings in our retirement security system. The individual account proposal, therefore, seems to imply a belief (1) that the government should promote retirement security by regulating the level of private savings for retirement, (2) that a greater portion of retirement income should be directly tied to individuals' levels of prior contributions, and (3) that a substantial portion of workers' Social Security pensions (ultimately about 30% for an "average" worker) should be at market risk in an "individually owned" account.

The Private Security Account (PSA) proposal put forward by another sub group of the 1994–96 Advisory Council carries some purposes of the IA proposal much further. By placing roughly one-half of current Social Security pension contributions (5% of payroll) in private accounts, the PSA plan would make a major shift from pooled to individually borne market risk and simultaneously eliminate much of the redistribution that is currently built into the Social Security benefit formula. Given its extremely low guaranteed public pension (410 1996 dollars per month) the PSA proposal shifts dramatically away from a public-insurance model guaranteeing adequacy in favor of a private-investment model emphasizing returns proportional to contributions.

In addition, the PSA plan has a semi-strong commitment to individual choice. While the level of personal savings for retirement is mandated, its investment form and the form of ultimate distributions are left to PSA owners.

Given this analysis it probably makes sense to think of only the IA and PSA proposals as "privatization" alternatives. The MB proposal maintains the current public commitment to defined benefit levels and to public management of all critical aspects of the system. Its only innovation is in investment policy for public funds, and that innovation is only tentatively supported.

EVALUATING ALTERNATIVES: NON-ISSUES

The critical question for the Congress is how best to think about these alternatives as it looks at possible changes in the Social Security system. While it is surely true that the devil is in the details when considering long-lived and complex systems, I would urge that Congress not be distracted by technical projections of the ultimate value of these proposals to individual beneficiaries (the "money's worth" debate) or by general claims about savings rates or economic growth. Neither of these matters turn on whether the system remains public or shifts to partial private ownership.

"Moneysworth"

The value of the system to the average beneficiary (or some subclasses of beneficiaries) is a function of a small number of variables: the amount saved, the rate of return on savings net of administrative cost, and the length of the accumulation period. Under similar assumptions concerning these variables returns are completely independent of whether the system is structured as a system of public accounts or a system of private accounts. The only possible qualification is that it is quite difficult to make the administrative costs of private accounts as low as the administrative costs of the current Social Security system, even with some investment of public funds in private markets. Hence, if similar amounts are put aside at similar gross rates of return for equivalent periods, a system of public rather than private investment is likely to have a slight edge in total returns.

Very different moneysworth projections for different groups can be produced by engaging in within-system transfers. And the returns to all workers can be changed by using other tax sources instead of, or in addition to, the payroll tax. But again these changes are quite independent of the legal form in which accounts are held, public or private.

National Savings

Shifting from public accounts to private accounts also has no effect on net national saving. A stylized example will illustrate this point. Assume that annual government spending is currently 100 and that the government's revenue sources are simple: it obtains 90 from general taxation and 10 borrowing from the Social Security trust funds (which are all held in the form of Treasury securities). Net private saving elsewhere in the economy is five. Because the surplus in the Social Security trust funds are exactly offset by the borrowing of those funds by the national government, there is zero net public saving. The net national savings rate—public and private savings combined—is therefore five.

Assume now that, in accordance with the proposal to invest Social Security surpluses partially in private equities, next year the Social Security system invests five in the private equities market. The national savings accounts will now look like this: Private savings are 5; Social Security savings initially are still 10 (although five will now be held in equities rather than Treasury bonds); and government savings still equal −10, unless taxing and spending rates elsewhere have changed. The only difference is that now 5 of the 10 previously borrowed from Social Security reserves must be borrowed elsewhere. Net national savings remain five.

The theory is that over time Social Security surpluses will increase by the amount of increased earnings on equity investments. This will allow taxes to go down, or not to go up, and some of those taxes not paid by workers will be saved. Net national savings thus go up by some amount *assuming that* government does not have to pay higher interest rates to borrow non-Social Security funds and increase taxation to pay the higher interest.

Transferring these same investments into private accounts has exactly the same effects. Because legal title has shifted we would now say that "private saving" is 10 and Social Security saving (reserves) is 5. But if general governmental saving remains -10, net national saving is still 5. The difference between public investment in private markets and private investment in private markets is in the accounting, not the economics. One could get new net national savings from mandating private savings only if the mandated savings (1) were not a substitute for saving that was already occurring elsewhere, and (2) not offset by reductions in prior levels of individual savings.

Put slightly differently, any changes in net national savings created by any of the Advisory Council's three plans would result from increased advance funding of Social Security obligations, changes in investment vehicles or higher contribution rates (taxes). None can be attributed to a difference between holding reserves in public or private accounts.

Moreover, the increase in national savings predicted for any of these approaches is premised on controversial economic assumptions. The public-accounts approach assumes that higher interest rates for constant levels of government borrowing, or increased government spending equal to the higher returns on Social Security reserves, will not eat up the gains from partial investment of reserves in equities. The private-accounts approach assumes, in addition, that new IAs or PSAs funded by contributions equal to 1.6% or 5% of payroll will not be offset by reductions in savings elsewhere (IRAs, 401k plans, etc.). The PSA proposal also assumes that massive government borrowing to fund the transition to the PSA system (equal to 40% of the existing national debt) will not increase the cost of government borrowing. All approaches assume that substantial additions of capital to equities markets will not affect historic average returns in these markets. These assumptions could hold true. But, then again, they may not. It would certainly be surprising if all of them were accurate predictions, rather than merely convenient assumptions.

The Real Questions

Given these uncertainties, the real questions for the Congress when comparing the proposals now on the table concern which system best protects the American worker and responds best to our overall notions of fairness in distribution. Neither consideration favors "privatization" that goes beyond investment of a portion of Social Security reserves in private markets.

The basic purpose of the Social Security pension system is to insulate Americans' retirement income from some aspects of market risk. These risks are of two quite different sorts. The first type is the risk of turning out to be a low wage earner over the course of one's working life, or of having that working life cut short by disability or death. Should any of these possibilities materialize, the worker will have much less capacity to save for retirement or provide for dependents. The Social Security system's redistributional formula for benefits ensures that in these eventualities dependents are protected and retirement income will not turn out to be too awful. The effects of the current Social Security system in drastically reducing poverty for beneficiaries attest to the system's success in accomplishing these goals.

The other type of market risk is the variability of returns to investments in private markets. This includes differences in returns given investment choices and the temporal risks that are inherent in the choice of a retirement age when that choice is not entirely voluntary. A cursory look at the short and long-term variation in mutual fund returns and at the erratic short-term behavior of the stock markets makes plain that neither of these risks is trivial.

Why would workers want to bear any of these risks individually if that could be avoided? In a rapidly changing economy most people feel an increasing loss of control over their long-term economic circumstances as wage earners. In the face of these large and perhaps increasing risks, pooling the risk of turning out to have had a relatively poor, lifetime earnings history seems prudent.

In addition, workers' other savings are virtually all at market risk. Why would workers want to trade a guaranteed public pension return for variable returns in the private market which, on average, will not dominate public pension returns (assuming, of course, investment of resources in instruments having similar yields). Because of overoptimism some workers might want to make this choice. But because on average workers simply cannot do better than average—this is not Lake Wobegon—there seems no reason for public policy to provide this option.

Substantial privatization of retirement account ownership would also drastically reduce the adequacy of disability insurance and survivors insurance benefits. For example, under the PSA proposal, average-wage workers disabled at age 50 would lose 25% of the replacement value of their current disability insurance. Low wage workers would lose proportionately more. Most workers would find it impossible to replace this insurance in private markets.

Privatization also carries with it substantial political risks to retirement security. IA and PSA accounts have been analogized to IRAs or 401k plans. But, as proposed by the ACSS Report, they are quite different. Unlike IRAs or 401k plans, IAs and PSAs are mandatory and yet unavailable for any purpose other than retirement. This is necessary if these arrangements are to hope to fulfill—even on average—the retirement income security purposes of Social Security pensions. But are these constraints sustainable over time? Can Congress year after year deny constituents access to *their own private* accounts for all manner of worthy purposes—obtaining life-saving medical care, preventing loss of the family home, avoiding the termination of childrens' college education, and so on? I, for one, am doubtful.

Finally, in terms of overall fairness, taking substantial portions of redistribution out of the Social Security system through the establishment of individually owned accounts moves in precisely the wrong direction. Because current income tax subsidies to retirement savings and the mortgage interest deduction enormously favor higher wage and higher wealth individuals, I can see no argument for restructuring the Social Security system to favor those individuals as well. A greater move toward tying returns to contributions within the Social Security system would be justified only if it were coupled with proposals to reduce or eliminate the tax expenditures that support the retirement savings of higher wage individuals under present law. These latter sorts of changes are highly unlikely.

In short, from the perspective of the income security of individual workers or from the perspective of the overall fairness of the retirement security system, individual ownership or individual ownership and management of Social Security accounts is unattractive.

Should We "Privatize" At All? I should add a final word on the desirability of investing Social Security funds in private equities markets. This proposal is preferable to maintaining a straightforward pay-as-you-go system in which tax rates are raised only as they become necessary to finance current payments. A pure pay-as-you-go system will put large burdens on future workers and/or reduce the value of Social Security pensions for all workers.

However, a complete pay-as-you-go approach is not the only one available to us. As we have seen, a combination of modest changes and an immediate small tax increase (1.1%) would do the job as well. Indeed, the tax increase would be smaller than those proposed by either the IA (1.6%) or the PSA (1.5%), and dramatically lower than that included in a privatization proposal recently put forward by the Committee on Economic Development (3.0%).

For this and other reasons I believe it was wise for the plurality of the Advisory Council to suggest merely that investment in private securities be studied. Not only are there important institutional questions to be considered, the secondary and tertiary effects of this approach on other investments, the total cost of Treasury borrowing, and the like, are not now well understood.

Chairman BUNNING. Eugene Steuerle.

STATEMENT OF C. EUGENE STEUERLE, SENIOR FELLOW, URBAN INSTITUTE

Mr. STEUERLE. Thank you, Mr. Chairman.

In the near future, this Subcommittee will inevitably be required to vote on major legislation to reform Social Security, and I would like to join others in applauding your current effort to prepare for this task by developing a framework to guide your deliberations. Only with a framework can one assess how to balance many competing objectives and goals, many of which are valid but compete with each other.

I suggest that your framework include the following: An historical perspective on the problems that force Social Security on the table; a set of principles, some process guidelines, and a more comprehensive measurement system that emphasizes the lifetime value of benefits and taxes or the insurance policy, essentially, that you are providing to individuals. Let me deal very, very briefly with each of these in order.

From an historical standpoint, in the early fifties expenditures on retirement, disability and health occupied less than 10 percent of Federal expenditures. Today they comprise almost 50 percent, and the number is continually rising. When the baby boomers begin to retire in the first third of the next century, the Federal Government could devote almost all its revenues to retirement and health, to the exclusion of everything else.

Now, this Nation, I believe, is committed to taking care of its most disadvantaged citizens, as well as trying to ensure a basic retirement living for our elderly. The current, unsustainable growth rate in retirement and health expenditures, however, in my view is helping to support disinvestment in our Nation and in our children's future.

Social Security and other government programs for the elderly and near elderly have several related problems. The one I would emphasize most is the huge decline in the use of our human capability and capital, but there is also some reason to believe that Social Security may reduce societal savings. These programs also are very inflexible, do a poor job of taking care of the very old elderly, as opposed to the young elderly, and they treat second earners in families unfairly.

All these reasons, I believe, give great weight to the notion that we should begin reform now, rather than later.

Now, it is the automatic growth in cost of the program, not so much the cost today, that leads to many of these problems. I would like to emphasize the three primary sources of growth in Social Security.

First, annual benefits are scheduled to grow forever, in real terms, for each succeeding generation of cohorts. Second, we live longer and retire earlier. Most of us now can expect to live approximately one-third of our adult lives in retirement, on Social Security.

And, by the way, Mr. Chairman, you asked earlier about the percentage of people who were primarily relying upon Social Security. Those numbers you were given did not take into account Medicare. The percentage would be probably in excess of 80 percent if we asked how many people were primarily reliant upon Social Security and Medicare for their well being in old age.

Now, there is a third source of pressure which is not under our control, and that is changes in birth rates and demographic patterns. This is a nontrivial change. The reduction in work force that is scheduled is equivalent, in order of magnitude, to an increase in the unemployment rate of about 10 percentage points. That is the type of demographic shift that we are going to incur soon, and very quickly, when the baby boomers retire.

Dealing with these problems, I believe, can best be done by reference to some basic principles and to some very important process guidelines. And again, let me mention a few very briefly.

I believe, like many, that the basic purpose of a governmental system of elderly support is to help those in their last years of life maintain an income level above poverty and to ensure that they receive some basic level of health services. But as much as possible, any government system should distort work, saving and other individual behavior as little as possible.

Therefore, the first principle in some ways is always going to conflict with the second one, and there is going to be certainly conflicts and disagreements among Members as to how to deal with them. Nonetheless, once the redistributive function has been accomplished, then government should be guided as much as possible by the principle of efficiency in allocating its resources.

There are a couple of budget principles, and I will not go through all of them again, as they are in my testimony. Among them I argue that future generations of voters should have the right to vote over how to spend money and that too much automatic growth in any problem—Social Security, Medicare, any—basically takes this right of voting away and violates budgetary principles.

I have also mentioned a couple of process guidelines, including the issue of dealing with Social Security and Medicare reform all in the same boat. To give you only one example why this is important, if you try to increase, the premium that individuals have to pay for Medicare, one way to compensate is to increase moderately the cash benefit given to low-income Social Security beneficiaries. If you separate the two programs, you cannot make these types of adjustments.

And finally, as my last point, I would like to recommend very strongly to this Subcommittee, when it thinks about measuring what is going on in Social Security, that it look at the lifetime value of the policy and not simply at the annual benefit. Remember that Social Security benefits are now scheduled for an individual to last about 18 years and, for a couple, to last about 25 years. That is a long time.

Even a low annual benefit, for many, many years of retirement support, can lead to the type of situation that we have today, where the lifetime value of a policy in Social Security for a couple is worth about $¼ million, and Medicare is worth almost $¼ million more, so that we are promising about a $½ million of benefits to couples retiring today, and that number is going up towards $¾ million in the future.

I would very much encourage you to look at lifetime values when you are thinking about how to do your reform.

Thank you.

[The prepared statement and attachment follow:]

Statement of C. Eugene Steuerle, Senior Fellow, Urban Institute

Any opinions expresed herein are solely the author's and should not be attributed to The Urban Institute, its officers or funders.

Mr. Chairman and members of the Subcommittee:

In the near future this subcommittee inevitably will be required to vote on major legislation to reform Social Security. I applaud your current effort to prepare for this task by developing a framework to guide your deliberations. Too many policy debates begin with proposed solutions even before the problems have been fully defined. Only with a framework can one assess how to balance competing objectives and goals and gain some sense of how different pieces fit together.

I suggest that your framework include the following elements: a nonpartisan, historical perspective of the problems that force Social Security on the table today; a set of principles that should undergird both current and future Social Security policy; some process guidelines; and a comprehensive measurement system that emphasizes the lifetime value of benefits and taxes under Social Security and other programs for the elderly and near-elderly. I don't mean to imply that this framework will lead to unanimous consensus over what should be done. It can, however, lay out in clearer fashion the benefits and costs of various actions and remove from consideration options that fail to address basic problems or that unnecessarily violate fundamental principles.

THE SOCIAL SECURITY "PROBLEM" IN HISTORICAL CONTEXT

Defining Social Security as a problem in some ways is like defining a cancer cure as a problem. Unlike crime rates, educational test scores, or children begetting children, most of our budgetary problems in the fields of health and retirement come from gains to society—not from a deterioration of conditions which may require new resources to redress. This should warn us that Social Security's budgetary "problem" derives more from an excessive set of promises than from new and unexpected needs.

As has been made quite clear by the trustees of the various Social Security trust funds, the promises of benefits within the Old Age, Survivors, and Disability Insurance (OASDI) are significantly in excess of the payroll taxes and other income sources available to the trust funds. You have received testimony on these issues and I will not dwell on them here. The problems posed by Social Security, however, extend far beyond mere adequacy of trust fund balances. In the early 1950s, expenditures on retirement, disability, and health occupied less than 10 percent of federal expenditures. Today they comprise almost 50 percent, and the number is continually rising. Social Security by itself is now over one-quarter of all federal expenditures other than interest on the debt. When the baby boomers begin to retire in the first third of the next century, the federal government could devote almost all its revenues to retirement and health to the exclusion of almost everything else.

This Nation, I believe, is committed to taking care of its most disadvantaged citizens, as well as trying to ensure a basic retirement living for our elderly. Nonetheless, needs compete for limited resources. We must choose wisely which additional dollars of resources can best be used to meet which additional needs. The current unsustainable growth rate in retirement and health expenditures, in my view, is helping to support a disinvestment in our nation's and our children's future. Our current budget, through rules that often operate automatically, effectively allocates larger shares toward retirement and health and smaller shares toward educating our youth, helping children who now have the highest poverty rates in the population, preventing crime, restoring promise and order in some of our central cities, or simply allowing individuals to keep more of their tax dollars. I don't mean to imply that making other budget choices is easy. We are on a path, however, that almost no one would choose, not even as a compromise.

Social Security and other government programs for the elderly and near-elderly have several related problems that go beyond their impact on the federal budget:

(1) First, they schedule and set in place a huge decline in the use of our human capability and capital. By encouraging longer and longer retirement periods relative to life spans—the very early withdrawal from the workforce of a large number of extraordinarily talented people—they reduce enormously the productive capacity of the nation.

(2) Second, our federal government increasingly favors consumption. Each year, it devotes larger budget shares toward higher levels of consumption and more years out of the workforce, rather than other longer-term objectives.

(3) Third, Social Security and other programs for the near-elderly and elderly, despite substantial resources, are very inflexible: they do a poor job taking care of the elderly poor, typically those who are very old, and they create a large number of inequities for second earners in families.

(4) Finally, there is good reason to believe that Social Security may reduce societal saving by (a) reducing the workforce and, thereby, leaving less societal income from which to save; (b) making large transfers from younger savers to older consumers; and (c) displacing some personal saving that would be made for retirement, although the claims in this last case are often exaggerated.

Although resolving these problems requires some difficult and fundamental decisions to be made in the near future, it does not mean that these decisions need to have a large impact on the elderly. With adequate forethought and preparation, reform can still mean that almost all future retirees receive greater or equal lifetime benefits than those who retired before them. Benefits generally can be maintained; it is the growth in benefits foreordained in current law that must be slowed.

THE BASIC SOURCES OF BUDGETARY PRESSURES

There are a variety of reasons for the past and future growth in the cost of Social Security. Three dominate. First, annual benefits are scheduled to grow forever in real terms for each succeeding cohort of retirees. Second, we live longer and retire earlier, and most of us can now expect to spend approximately one-third of our adult lives in retirement, during which period we will be primarily dependent upon younger taxpayers for our income and health care support. Without increasing early and normal retirement ages in Social Security, the fraction of our lives during which we would receive government support would rise even more. Third, changes in birth rates and related demographic patterns now mean that just around the corner there will be a reduction in the workforce that is equivalent in its economic impact to an increase in the unemployment rate of over 10 percentage points.

This last source of pressure is unavoidable. No matter how we define "old age"—for example, by a given life expectancy—the proportion of the population that is closer to death will soon rise dramatically, with most of the change occurring during about a twenty year period when the baby boomers become "old." Needs of the "old" will increase during this period and require adjustments in federal outlays.

The two other sources of pressure, however, could be placed more under control. Growth in real benefits per person can be pared, as can the number of years of promised support. After taking into account earlier retirement, remember that the typical annuity for an individual now lasts about 18 years and for a couple about 25 years. Some combination of these changes alone could bring the Social Security system into budgetary balance.

The simple fact is that future cohorts of individuals in their 60s and even early 70s will not be "old" by traditional standards of having short expected life spans. As a whole, moreover, this age group is already among the richest and most capable of all age groups, while our societal standard—both public and private—is to treat them as unproductive and create incentives to move them out of the workforce.

The pressure put on younger workers is already significant, with about $1 in $5 of their cash earnings already being transferred to support federal programs for the elderly and near elderly, some additional amount going to state and local programs for the elderly and near-elderly, and the effective federal tax rate projected almost to double in coming decades due to a scheduled drop in number of workers to retirees and the lack of control over health costs.

FIRST PRINCIPLES

Dealing with these various issues and problems can be done best, I believe, by reference to basic principles and then making appropriate trade-offs among them.

Principles of Social Security

The first set of principles relates to the fairness and efficiency of Social Security itself:

(1) Addressing Fundamental Needs. The basis purpose of a governmental system of elderly support is to help those in their last years of life to maintain more than poverty level income and insure that they receive a basic level of health services. Social Security's success here has been remarkable and should not be abandoned wantonly.

(2) Equal Treatment of Equals. All law should promote equal justice—in the case of Social Security, avoid any arbitrary or capricious difference in taxes or benefits among those who are more or less equally situated.

(3) Efficiency. As much as is reasonable, the system should not distort work, saving, or other individual behavior.

(4) Individual Equity. Individuals have the right to receive a fair return on their transactions.

The first principle almost inevitably requires some redistribution in society—from young to old and from rich to poor—and hence conflicts with the third and fourth principles. Alternative reform proposals place different emphasis on different principles. Nonetheless, once the redistributive function has been accomplished, the government should be guided as much as possible by the latter principles in allocating its resources.

In a society providing minimum levels of benefits to individuals, moreover, each individual carries some responsibility to avoid relying upon others. If you and I have equal lifetime incomes, but you save and I spend during our earning years, then in a simple welfare system you would end up paying for my retirement, as well as your own. Social insurance, therefore, carries along with it obligations to pay as well as rights to receive.

Principles of Budget Policy

A second set of principles applies more broadly to budget policy, which seeks over time to allocate scarce resources to the greatest needs and demands of society:

(5) Ownership of Government. Future voters and generations have a right to some ownership of government and to a say in how to allocate the additional tax resources that accompany economic growth.

(6) A Level Budget Playing Field. Different items in a budget should not arbitrarily be divided into those that grow rapidly with only minority support and those that decline unless they can obtain the backing of a supermajority. (By minority support, I refer to the ability of a majority of one in either house or a President by himself to block changes favored by a majority; by supermajority, I refer to the need to obtain a majority in both houses of Congress and Presidential approval.)

(7) A Comprehensive Budgetary Perspective. To promote both equity and efficiency, when different programs have related goals, they need to be considered as a whole.

These latter issues are often ignored when budgetary decisions are taken one at a time or put into strict compartments. In the United States today, as well as much of the industrial world, programs for health and retirement have begun to dominate other budget items and are scheduled automatically to absorb more than all of the revenue growth that accompanies an expanding economy. The uneven playing field of the budget—the so-called entitlement problem—means that over the long-run items such as education and the environment receive smaller shares of funding so as to support significant growth in expenditures for retirement and health. Put another way, our government resources are increasingly and automatically devoted to consumption in old age relative to education of our youth, greater crime prevention, a fixing up of our central cities, and simply getting our youth off the streets after school and during summers.

Good budget policy, therefore, tries to avoid excessive promises even if rising incomes in theory make such promises affordable. Ownership of government is reserved for each future generation not simply as a matter of right or of justice, but because we are humble enough to admit that we do not know today all the circumstances that will arise tomorrow. Perhaps programs for the elderly should be even larger than anyone contemplates, maybe taxes will have to be devoted instead to problems not even anticipated. To lock into law benefit and tax increases for the future that can only be overturned by a future supermajority, however, borders on being an act of distrust in democracy itself.

Any set of proposals for Social Security reform should be assessed by reference to this type of set of fundamental principles.

Process Guidelines

In addition to basic principles, it is important that any reform effort begin with some process guidelines. Let me suggest three that are important for Social Security.

First, Social Security reform must bring long-run revenues and expenditures into line and not depend upon perpetual, long-term, deficit financing within Social Security itself. We cannot consider our problems solved if we merely reach 75-year balance of receipts and expenditures, a traditional Social Security goal. Such a balance implies that after a few years of surplus in the current period, due largely to the relatively small birth cohort now retiring, Social Security can run perpetual deficits that will be financed by the general taxpayer, who pays for the interest or redemption of principal of moneys attributed to the trust funds. This is foolhardy. Long-run expenditures and sources of funds must also be brought into line.

Second, reform of programs for the elderly, as much as possible, ought to be considered as an integral whole. There are very important interactions among Social Security, Supplemental Security Income (SSI), and Medicare, among others. For example, if Social Security and Medicare were considered together, I believe that we would be less likely to continue the trend toward increasing Medicare benefits relative to cash benefits. Some worthwhile trade-offs would become more apparent, such as increasing cash benefits for some poor elderly in exchange for more tightly controlled Medicare expenditures. As another example, transfers to the poor through SSI or Social Security should be integrated.

Third, reform ought to center on long-run structural, not short-term cash flow, problems. To achieve this goal, reform should begin as soon as possible. When the baby boomers begin retiring, the fiscal impact of paying off the many new unfunded promises made to them hits with a bang. The longer we continue to delay dealing with Social Security's problems, the more likely legislation will be centered on cash flow fixes, rather than long-term reforms. For instance, increasing tax rates or cutting back on cost-of-living adjustments can add quickly to trust fund balances. Raising the retirement age, reducing the rate of growth of unfunded benefits for each new cohort of retirees, or gradually building up private funds and saving, on the other hand, occur only gradually over time. One reason for gradual implementation of the latter reforms is to avoid large differences in benefits between new retirees from one year to the next. While the cash flow revisions add quickly to trust fund balances, they often fail to deal with the issue of how Social Security should be structurally designed for the long-term.

Finally, any accounting system should be complete. It should account not only for what is happening to Social Security, but to the government budget as a whole, and to private individuals as taxpayers, recipients, and savers. As one example, it is important to beware of magic money that derives from incomplete accounting. Attempts to let government borrow at a 2 percent real interest rate and then encourage government accounts or private accounts that supposedly grow at a stock market rate of, say, 6 percent are misleading, if not dangerous. Orange County writ large. If government can win by arbitrage, then someone else is losing. If one really believes that all government has to do is to arbitrage some money to solve its long-term problems, then let's simply increase government borrowing even more and then invest that money, or force private savers to put money aside, in the stock market! Magic money is being used by some to argue that hard choices don't have to be made. That is, it is tempting to promise continued huge increases in the elderly and near elderly's share of the national pie simply by having their money grow faster than the economy—that is, faster than income and consumption of everyone else. Not only is magic money often involved, but even if available it doesn't solve many of the longer term problems associated with the waste of our human capital or capabilities.

MEASURING LIFETIME BENEFITS AND TAXES

Social Security reform discussions often start with too narrow a focus—the value of annual benefits for particular sets of beneficiaries. While this measure is adequate for some purposes, a more comprehensive way of viewing Social Security requires looking beyond annual costs toward the value of expected lifetime benefits—the amount of money it would take for households to buy a private insurance policy that provided equivalent benefits.

With a lifetime perspective, it is easier to view many of the trade-offs comprehensively. For example, recent debates over cost of living adjustments have focused on their impact on annual benefits. If one wants to reduce lifetime benefits by 10 percent, however, it may be better to cut back on benefits of the young elderly than on the old elderly, who are most affected by cost of living adjustments.

Lifetime benefits allow one to consider more directly the choice made between higher annual benefits and more years of support. For a couple retiring at age 62 today, annuity payments can be expected to last for one-quarter of a century on average. That is, because Social Security operates like an insurance policy with a right of survivorship, the longer living of the two partners will on average receive 25 years worth of Social Security benefits. For any lifetime benefit package, reducing years of expected support allows one to maintain higher annual benefits.

The combination of real growth in annual benefits, combined with more years of retirement support, has led over time to a significant increase in lifetime benefits. For an average-income one-earner couple retiring at age 65 in 1960, for instance, total Social Security cash benefits were worth about $99,000 (in 1993 dollars). Today those benefits cost about $223,000. In another 25 years, the Social Security pensions of new retired couples with average incomes will have a value of about $313,000 (see Table 1). Remember again that one reason these lifetime costs are this high is that benefits are scheduled to last for more than two decades.

Until recently, almost all recipients—whether rich or poor—received more in benefits than they paid in taxes and the interest they could have earned on those taxes. Those who were richer, moreover, consistently received transfers (benefits in excess of taxes) as large, if not larger, than those who were poorer. To take an example, low-income couples retiring in 1980 paid into the system about $27,000 in taxes and got back $150,000—a net transfer of $123,000. High-income couples retiring in that year paid in about $83,000 in taxes, but got back $316,000—a net transfer of $233,000. Only now and in the future will that situation gradually begin to reverse itself—and even then low-income households will sometimes receive fewer net OASI transfers than those with higher incomes.

When Social Security and Medicare benefits are added together, an average-income couple retiring today is promised benefits not far from 1/2 million dollars—growing toward $800,000 by the year 2030. For some high-income couples retiring in the future, the value of benefits will approach 1 million dollars.

CONCLUSION

I have suggested that a framework for reform should give considerable attention to historical context, principles, process, and use of comprehensive measures. While a good framework will not provide any final answers, it will help focus attention on the main issues at hand and help keep poorly designed options off the table. If the subcommittee can achieve those objectives, it will have advanced the Social Security debate by several stages and have made it much easier to develop a system that serves the needs of citizens in the next century.

TABLE 1

ANNUAL AND LIFETIME SOCIAL SECURITY AND MEDICARE BENEFITS AVERAGE WAGE ONE EARNER COUPLE

1993 DOLLARS

	Annual Benefits		Lifetime Benefits Assuming Survival To Age 65	
Year Cohort Turns 65	Social Security	Medicare	Social Security	Medicare
1995	$14,600	$9,600	$237,000	$232,000
2030	$20,800	$26,400	$324,000	$497,000

Notes: Data are discounted to present value at age 65 using a 2 percent real interest rate. Table assumes arrival to age 65 and retirement at the OASI Normal Retirement Age.

Source: C. Eugene Steuerle and John Bakija, Retooling Social Security for the 21st Century: Right and Wrong Approaches to Reform, 1994. Projections based on intermediate assumptions of the 1993 Social Security Board of Trustees reports, adjusted by the authors for the estimated impact of 1993 enactments.

Chairman BUNNING. Thank you. Dr. Myers.

STATEMENT OF ROBERT J. MYERS, LL.D., SILVER SPRING, MARYLAND; (FORMER CHIEF ACTUARY AND FORMER DEPUTY COMMISSIONER, SOCIAL SECURITY ADMINISTRATION; AND FORMER EXECUTIVE DIRECTOR, NATIONAL COMMISSION ON SOCIAL SECURITY REFORM)

Mr. MYERS. Thank you, Mr. Chairman. I shall first discuss the current financial status of the Social Security program as it is shown in the 1996 trustees report. The 1997 trustees report was due April 1, but it has not been filed yet. Next, I will talk about what I consider to be the underlying principles of the Social Security program. Then, I will describe certain widespread misconceptions about it. Finally, I will give my solution to the financing problem that is very likely. My solution has some of the points of the Advisory Council proposals but also differs and, in combination, it is quite different.

As to the long-range financial status, at the end of last year, the trust funds had a balance of $567 billion. The excess of annual income over outgo in the next few years will be as high as $60 billion up to over $100 billion, and eventually the trust funds will peak at about $3 trillion in 2019 and then will decrease until being exhausted in the year 2029, according to the intermediate estimate. I emphasize, according to the intermediate estimate, because that is not a certainty.

The long-range situation is that there is an actuarial imbalance of about 2.2 percent of payroll for the 75-year period. That is a significant figure, but it is not an overwhelming one.

The situation under the low-cost estimate, which is a valid estimate, is much more favorable. In fact, there is no financing problem at all under the low-cost estimate, not only in the 75-year period, but for all time to come.

One reason the low-cost estimate has a certain validity these days is because of the possible changes in the CPI that have been mentioned. If we have a 1.1 percentage less increase in the CPI each year, two-thirds of the long-range problem would be solved, and the other one-third could be solved very easily by relatively minor changes.

As to the underlying principles of the program, it is compulsory and has almost universal coverage. It provides a basic economic floor of protection with benefits heavily weighted for the lower paid people, to take care of the social adequacy aspects. It should be emphasized that the program is an economic maintenance program, and not an investment program.

Therefore, in my view, moneys' worth analyses or rate-of-return analyses on the taxes paid are interesting, but not really relevant or applicable. This is somewhat similar, although not as extreme, as school taxes, where the person who has a big mansion pays many times the school taxes that somebody who has a modest home does, and even though they have the same number of children, and thus they each have the same benefits, one pays much more than the other. Or, in fact, going even further, people who never have children pay school taxes, and they get no benefits from them, other than the very broad national benefit that it is desirable to have an educated population.

There are certain widespread misconceptions about the Social Security program. The first is that the system is certain to be bankrupt soon. As I indicated, this is not at all certain. Making actuarial estimates for long-range periods of time is not a precise science, and it is quite possible, particularly if the CPI is reformed, that this problem will be greatly deferred.

The second misconception is that there are unbearable costs over the long run. I don't think that this is true, because any problem can be solved relatively easily by either small decreases in benefits and/or increases in contribution rates.

Another misconception is that the trust fund investments are worthless IOUs. People state this and say that the money has been spent. Well, in the same way, the money has been spent for any government bonds or any bonds that are sold by corporations. Some persons say that the interest is not usable. Actually, it can be demonstrated that the interest is used every month.

It is said by some that Social Security is a poor investment for any purpose. As I have said, that is not the purpose of Social Security, to be an investment program.

The final misinterpretation is that Chile has the perfect Social Security system because it is privatized, and we should do the same. People do not realize the differences between here and Chile. Chile is financing the huge transition costs through the fact that they have budget surpluses. We have budget deficits, and you cannot finance anything with a budget deficit.

My solution is the time-tested procedure of reducing benefit costs—by raising the retirement age. I would go up, not to 67 as under present law, but rather as far as age 70, very slowly and gradually, by the year 2037. I would increase tax rates by 0.3 percent each on the employer and the employee in 2015, 2020, 2025, and 2030. And if this were done, there would also not be the problem at the end of the valuation period of benefit costs thereafter greatly exceeding tax income.

I would also reduce the tax rate that goes to Social Security in the next 10 or 15 years and transfer that money to Medicare's Hospital Insurance Trust Fund, because I think the Social Security trust funds are building up too rapidly.

Finally, I would establish a new, separate, compulsory individual account program on top of the reformed Social Security program, to be invested at the choice of the person in the private sector, but I would exclude very low-paid persons, for administrative cost reasons, because the administrative expenses would eat up so much of the contribution.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Robert J. Myers, LL.D., Silver Spring, Maryland; (Former Chief Actuary and Former Deputy Commissioner, Social Security Administration; and Former Executive Director, National Commission on Social Security Reform)

Mr. Chairman and Members of the Subcommittee: My name is Robert J. Myers. I served in various actuarial capacities with the Social Security Administration and its predecessor agencies during 1934–70, being Chief Actuary for the last 23 of those years. In 1981–82, I was Deputy Commissioner of Social Security, and in 1982–83, I was Executive Director of the National Commission on Social Security Reform (Greenspan Commission). In 1994, I was a member of the Commission on the Social Security "Notch" issue.

In this testimony, I will first analyze the current financial status of the Social Security program (Old-Age, Survivors, and Disability Insurance, or OASDI), and I will then describe its basic underlying principles. Next, I will discuss some of the misconceptions of these principles, which misconceptions lead some persons to recommending that the program should be radically changed by either wholly or partially privatizing it. I shall not analyze or criticize these various proposals, but I will briefly give my views as to what changes should desirably be made.

Current Financial Status of the OASDI Program

At the beginning of this year, the assets of the OASDI Trust Funds amounted to \$567 billion. Virtually all was invested in federal obligations that are part of the National Debt, redeemable at par on demand (plus accrued interest). The interest rate on these securities when they are issued, as set by law, is the average market interest rate on all federal bonds having a maturity date of at least 4 years in the future. The rate on such securities issued in 1996 varied from 5.875% to 7.0%.

Under the intermediate-cost estimate in the 1996 Trustees Report, the trust-fund balance will grow steadily—by as much as \$125 billion per year in the early 2000s—reaching a peak of \$2.9 trillion in 2018 and 2019. Thereafter, if present law is not changed (which, I believe that it most certainly will), the balance will decrease and become exhausted in 2029.

Another way to look at the financial status of OASDI is to consider the estimated actuarial imbalance over the next 75 years. According to the intermediate-cost estimate, this is 2.2% of payroll, meaning that the employer and employee tax rate would each have to be immediately increased by 1.1 percentage points in order that outgo would be fully financed by income over the next 75 years. An increase of such small magnitude would hardly be "unbearable" to preserve what is generally considered such a valuable program. The drawback would be that extremely large fund balances would be built up in the next four decades and then torn down, which would create almost untenable problems during both periods.

Such a financing problem would not occur under the low-cost estimate, but would, of course, be worse under the high-cost estimate. The assumptions used in the low-cost estimate are reasonable, although it is not likely that the actual experience will follow all of them. Fiscal prudence dictates that remedial action should be taken soon, although any changes should be made first effective many years hence, when it is clear that there really is a long-range problem; if it turns out that there really is no problem, then the changes can be repealed or lessened.

The future outlook as to one assumption is currently very favorable—namely, the annual increase in the Consumer Price Index. Many persons believe that this is overstated and that, accordingly, the CPI should be drastically revised. One widespread view is that such overstatement is about 1.1 percentage points per year. If such is the case for this one factor, the long-range deficit under the intermediate-cost estimate would be reduced by two-thirds, and the point of exhaustion of the fund balance would be deferred until the 2050s. Any program changes needed to close the gap would be relatively small.

Underlying Principles of the OASDI Program

Over the years, the OASDI program has generally been considered to have the basic purpose of being an income maintenance program that provides a basic economic floor of protection in the event of disability and old-age retirement or in the event of death of the breadwinner. It is intended to be almost completely financed by contributions (taxes) from workers and employers and from a portion of the income taxes that are levied on Social Security benefits. It is not intended that the benefits of each worker are to be completely financed by her or his own contributions and those on her or his behalf by the employer. Rather, it may properly be said that the worker contributes toward her or his own benefits, but does not actuarially "purchase" them.

Although the employer contributions are, in the aggregate, part of employee remuneration, they are not individually assignable as a property right to each employee. Rather, they should be viewed as pooled for the program's general purposes—to meet the cost of the benefits for high-cost groups, such as those who were near retirement age when the program began, low-earning workers, and workers with qualifying family members. This practice is generally followed in benefit plans of private employers. One such example is when an employer adopts a maternity-benefits plan for the female workers, instead of giving all workers a wage increase; the male workers have not been inequitably treated, even though they will receive no benefits.

On the other hand, OASDI is not intended to be an investment program, under which all covered individuals get their money's worth in protection, no more and no less. To put it another way, each person does not get the same—presumably, high—internal rate of return on her or his taxes.

Similarly, school taxes should not be considered as an investment program (except, broadly, from the standpoint of the nation as a whole). The owner of an expensive house pays many times the school taxes as the owner of a modest one with the same family composition, but yet receives only the same education-benefit protection. Also, the person who never has children obviously does not get her or his money's worth. Nor can people cease paying school taxes when all their children become adults.

Those who retired in the early years of operation of OASDI received large "actuarial bargains" because their total taxes were relatively small, but they frequently supported their aged parents, because they did not qualify for Social Security benefits. On the other hand, current workers, who pay relatively high OASDI contributions, rarely do so.

Misconceptions of the Underlying Principles of OASDI

In recent years, several misconceptions about the underlying principles of the OASDI program have emerged. These have resulted in greatly reduced confidence as to its long-term viability, as well as growing demands for its dilution (or even elimination) through so-called privatization.

(1) "Certain to become bankrupt soon."

As discussed previously, the intermediate-cost estimate shows that the trust-fund balance will peak in 2019 and become exhausted in 2029. Some individuals note that payroll-tax income will fall short of meeting outgo in 2012 and subsequently; this is not of significance, because interest income is also available, both before and after 2012. All these points in time are cited as evidence of certain near-future bankruptcy.

(2) "Unbearable cost over the long range."

Some persons assert that the cost of OASDI will ultimately (in 50–75 years) be as much as 40–55 percent of payroll—and thus obviously unbearable. Such a cost includes the employer payroll tax and the cost of the Hospital Insurance program (and, sometimes, the cost of the Supplementary Medical Insurance program expressed as a percentage of taxable payroll, even though it is not financed in that way), and is based on the high-cost estimate. Under this basis, there quite naturally would be a huge long-range actuarial imbalance; this would undoubtedly be rectified well in advance by changes in benefits and financing.

Further, some critics assert that very large budget deficits and increases in the National Debt will result. They do not note that, in the past, the OASDI program, due to its self-supporting nature, has not contributed at all to the general budget deficits (and, if anything, has hidden them) or the increase in the National Debt. As long as this principle is maintained by appropriate changes in the benefit structure and the financing, the OASDIprogram never will have such an effect.

(3) "The trust-fund investments are worthless IOUs."

Some persons assert that the government securities in the trust funds are valueless, because they are nonmarketable "IOUs," and that, moreover, the government "has already spent the money on many different things." Just as bonds issued by a private company or a deposit in a savings bank, the money involved—although having been spent, for the purpose that the bond was issued or in the way that the bank lends its deposits—represents a valid interest-bearing debt. The characteristic of being redeemable at any time—the same as the Series E government bonds widely sold to the general public—is, at times, more advantageous than being marketable (and, at other times, the reverse).

(4) "The interest on the trust-fund investments is not usable."

Critics often say that the interest on the trust-fund securities is never usable. They assert that, during the next decade or so, when the income from payroll taxes exceeds outgo, the interest is not used, but rather is merely put into more "worthless IOUs." Further, after that time, they argue that new taxes or borrowing will be needed to pay such interest. However, they do not consider that, if the trust funds had not had the money available to purchase these securities, then the general public would have done so—and the same interest payments would have been made.

Because the Treasury checks for the periodic interest payments are mingled with the payroll taxes paid by employers, it is usually impossible to determine which of these two sources of income are used to meet outgo and which are left over to purchase government securities. One instance, however, is quite clear. Like any good money manager, the trust funds invest daily any excess of income over outgo. Then, at the beginning of each month when about $30 billion of cash is needed to pay benefits, existing investments are redeemed. However, somewhat less than $30 billion of securities is redeemed, because the accrued interest on the redemptions makes up the difference.

(5) "Chile has the perfect social security program."

Many critics of the OASDI program who propose cutting it back by partially privatizing it (or even eliminating it by full privatization) assert that Chile has been a great success in its replacement of a floundering traditional social insurance system in the early 1980s by a fully privatized program. The new Chilean program has been reasonably successful, but it was not the only solution that could have been adopted, and it is by no means "perfect."

Furthermore, conditions in Chile were relatively quite different than in other countries, so that what worked out well there would not necessarily do so elsewhere. Chile had large budget surpluses that were used to finance the emerging transition costs (prior-service credits) and the generous minimum-benefit provisions; such financing may be a serious problem over the long range. On the other hand, other countries generally have budget deficits and so cannot follow this course of action. Chilean government bonds are price-indexed and, in the past, bore double-digit coupon rates. So, it is not surprising that the pension companies, with about 40 percent of their assets so invested (and with their holdings in private bonds and bank deposits necessarily having to be competitive as to investment returns), have shown very successful investment experience.

Still further, coverage compliance is poor (although greatly improved over the old system). The administrative expenses of the retirement-benefits portion of the system are relatively high—about 13 percent of contribution income (as compared with less than 1 percent for OASDI).

(6) "OASDI is a Ponzi, chain-letter, or pyramid scheme."

Some critics of the OASDI program assert that it is a hoax and lie, because it is a Ponzi, chain-letter, or pyramid scheme, which of its very nature will inevitably ultimately collapse. Under those three types of plans, operations can continue over long periods only if there is a continuing geometrically-increasing number of contributors each year—an impossibility, of course.

The OASDI program is quite different. All that it requires for long-range financial stability is that the ratio of contributors (active workers) to beneficiaries will ultimately stabilize at a reasonable level. That result will be achieved, almost certainly, under normal demographic conditions. At worst, it can be accomplished through appropriate deferred, gradual increases in the "full benefits" retirement age (now 65 and scheduled to rise to 67 in 2027), so as to recognize increasing longevity over time.

(7) "OASDI is a poor investment for many persons."

Many individuals—particularly young, high-paid ones—complain that OASDI is a poor investment and that, even if the program is viable over the long range, they do not get their "money's-worth" in benefits from the payroll taxes paid by them and their employers. This represents a gross misunderstanding of the basic purpose of the program, as discussed earlier.

If people are allowed to opt out of OASDI and make their own investments to take care of their retirement, it is true that many would be successful—although others would not. Due to the "actuarial law" of anti-selection, the relative cost of the program for those remaining in it would rise, and there would be increased public-assistance costs with respect to those who opted out and failed to make good investments. Such costs would have to be met by society as a whole and would largely fall on those who believed that they had "successfully" opted out to their own financial advantage.

My Solution to Financing Problem of OASDI

I would solve the problem by the traditional, time-tested way of combining, more or less equally, benefit-cost reductions and tax-revenue increases—all done in a deferred, gradual manner, although enacted into law now.

The "full-benefits retirement age" should be increased to 70 in 2037, and the employer and employee tax rates should be raised by 0.3 percent each in 2015 and then again in 2020, 2025, and 2030, making a total increase of 1.2 percent each. Although in some quarters, a proposal to increase taxes is virtually equivalent to blasphemy and advocating economic collapse, I do not believe that such small intermittent increases (even if the employer passes them on to workers through lower periodic wage increases) would be harmful under the likely future circumstances of slow, continuous growth in real wages that will almost certainly occur over the long run. This package of changes would definitely restore the long-range actuarial balance of the OASDI program, under the intermediate-cost estimate.

If the correction in the method of computing the CPI were as large as some experts recommend, the changes could be much less, possibly confined only to raising the full-benefits retirement age (and then not to as great an extent).

Also, I believe that the OASDI-Hospital Insurance taxes for 1997–2009 should be reallocated so that the total OASDI taxes are reduced by reducing employer and employee rates by 0.6 percent each, and those amounts are then transferred to the HI Trust Fund. This has a double advantage—(1) the excessive growth of the OASDI Trust Funds is reduced, and yet the fund balances are ample and (2) the HI Trust Fund will be in a satisfactory cash-flow position for at least a decade, and there will be sufficient time to work out a long-range solution. At the same time, the total taxes paid by employers and workers will remain unchanged, and there will be no effect on the general budget deficit or the National Debt.

Finally, I favor the adoption of a compulsory individual-savings-account plan to supplement a reformed, fiscally sound OASDI program. This would involve an additional employee contribution rate of, say, 2 percent. Such amount would be directed, at each individual's choice, to an appropriate, government-regulated private organization, such as a mutual fund, insurance company, or bank. The only exception would be that persons with low total earnings (say, under $5,000 per quarter) would be exempt, by having the contributions refunded, because the small amounts involved could not be handled in a cost-effective manner.

Chairman BUNNING. Thank you all for your testimony. I want to ask one basic question of all of you and then I will ask some individual questions.

Of the four of you here, how many think that we should address sooner, rather than later, what is considered a problem with Social Security's long-term solvency? Dr. Myers actually does not believe that we have a problem.

Mr. MYERS. No, I say we may not have a problem.

Chairman BUNNING. I know. Let the other three handle this one and we will get back to you.

Mr. MYERS. Excuse me, Mr. Chairman. I would be in favor of addressing it now, with the action to be deferred until later.

Chairman BUNNING. OK. Go ahead, Dr. Butler.

Mr. BUTLER. I think it is clear that we should be addressing it now. Much of my work, besides this area, is on Medicare, where I think we are seeing the results of not addressing a problem very early. We now have very limited solutions, which are very unattractive for Congress.

I think clearly the more rapidly we deal with this, the better. We also have a baby boom generation that is of an age now where it might contemplate some structural reforms. I suspect, when that baby boom generation starts getting 60 to 65, your options for making reforms will become dramatically lower. So the sooner, the better.

Chairman BUNNING. Dr. Mashaw.

Mr. MASHAW. I agree with Stuart. I think we should act soon. I think that the political difficulty is there is no current crisis.

Chairman BUNNING. We understand that. That is always the way we act in the Congress.

Mr. MASHAW. And in the absence of a crisis it is difficult. Stimulating a crisis in order to get action may produce action which one does not want to take.

Chairman BUNNING. No, we do not want to stimulate the problem. It is enough of a problem as it is.

Mr. STEUERLE. Mr. Bunning, I think sooner is clearly the right answer, but let me indicate that one of the reasons is a technical one having to do with drafting.

Let's suppose you really want to achieve a long-term solution, such as increasing the retirement age. The only way really to do that is to do it gradually over time, increase the retirement age 1 or 2 months per year every year, so that gradually we implement a higher retirement age.

If you wait until something like 2010, we cannot go to people and says, “Whoops, we are out of balance by 25 percent; we are going to increase the retirement age. For people who retire today, the retirement age it is going to be 65; for people who retire tomorrow, it is going to be 70.” It just does not make sense.

Chairman BUNNING. We have a window of opportunity within the next, I would say, 7 or 8 years to do this properly.

One of the things that I question you all about is that people under 40 have more confidence that there are UFOs than they do that Social Security will be available for them when they come to retirement age.

How do you overcome that without a fix that assures them their benefits will be there? They don't feel they own any part of their contributions to Social Security right now. Any of you may answer.

Mr. BUTLER. I have no position on UFOs or the feasibility of them exactly but—

Chairman BUNNING. I don't, either.

Mr. BUTLER. I think there is both a concern and an opportunity in what you say. The current concern is, of course, a lack of knowledge about what the situation really is. I think that is one important reason for getting better information, including rate of return information, for those individuals so that they can actually see the picture.

I think there is an opportunity in the sense that we could consider some changes now in the system that would not have an effect on beneficiaries for many years. This would be quite acceptable to young people who do not think they are going to get much anyway out of the system. So they are very inclined to look at changes in the system that might, in fact, reduce what they do not think they are going to get anyway, and therefore you have a political opportunity there.

Chairman BUNNING. But still and all, they are paying their FICA tax, so they would like to see some of their contributions where they can put their hands on it, rather than the Government doing it.

Mr. BUTLER. Oh, I agree.

Chairman BUNNING. You have to overcome that.

Mr. BUTLER. Yes, indeed, and I agree we should try to accomplish their objective. But I think that in the time being, they think largely of FICA tax as another tax that just goes to the Government.

Chairman BUNNING. That's 15 percent off the top.

Mr. BUTLER. Yes, I know. It is a heavy tax.

Chairman BUNNING. Roughly 7.5 from employer and 7.5 from employee.

Mr. BUTLER. But to the extent that people feel that way——

Chairman BUNNING. Their employer could give them another 7.5 percent.

Mr. BUTLER. But to the extent they feel that way, I think it means that it opens up options for making changes that would be acceptable to them, even under——

Chairman BUNNING. If we do it sooner, rather than later.

Mr. BUTLER. Exactly.

Mr. MASHAW. Just two points. I think first of all, one should look not only at public opinion polls here but also at behavior. When younger workers are told that their retirement benefits are being figured by taking into account the expectation that they will be paid Social Security benefits, they are not telling their employers that they have to put more into their retirement savings plan, because the Social Security is not going to be there. So there is some divergence between behavior and reported opinion.

And second, it seems to me that one has to also consider, when one is thinking about public opinion about the security of the funds, what is going to happen to the funds if they are in private accounts, as against public accounts? We may have one problem now. Retirement funds are in public accounts and the Government can do what it wants with them. That may make people insecure.

The alternative problem is to say to people that the funds are theirs, they own it. But they cannot do anything with it except hold it till retirement. What if they need life-saving medical treatment; they need money to keep their kids in school; they need money in order not to default on their home mortgage, and so on. The Congress has responded to those sorts of claims with respect to IRAs recently. It is very hard to see that similar diversions could be resisted over time in private retirement accounts. So we have a retirement security problem there, as well.

Chairman BUNNING. OK.

Mr. STEUERLE. Mr. Chairman, I talk to a lot of groups around the country and actually, I find that not only are most young people willing to reform Social Security but I think most old people are also. I think they recognize it is a problem. They do not trust necessarily the people who are going to make the decisions all the time, but they recognize there is a problem and if they thought that reform was really being done in an impartial way, they would accept it.

I think one of the biggest problems for young people, as I tried to mention, is that as long as you have this automatic growth in the budget that is so great—this is more of a budget issue than just purely a Social Security issue or a Medicare issue—as long as so much growth is automatic and all the revenues that government gets every year are spent because they are due to legislation we enacted in the past, I think younger voters and generations feel like they do not own government, that they have no real say over it.

I know a number of Members of Congress who resigned on that basis, that "we" are not deciding anything, because everything is decided already by this automatic growth, and we are just basically in there trying to constantly cut the deficit and cut back on the promises.

The system as a whole has to be brought to the point where it is clear that the promises can be met. We might debate about what those promises should be and how we might change them over time, but if we get to a system where it is clear that the promises that are made can be met, I think young people would be much more likely to trust in government than they do today.

Chairman BUNNING. Dr. Myers.

Mr. MYERS. Mr. Chairman, as to restoring confidence of young people that there will be some system, I think the answer to that is the question you raised previously. Reform the system now, even though the changes might be deferred off into the future, and if people are told that according to the best professional judgment, the system is viable and will be there, I think that confidence will be restored.

I believe that young people do feel that way, that only 25 percent or so believe that the system will be there. I can understand why they think that. I think they are wrong. But as to the UFO question, I think really it is the old story: Ask a silly question and you get a silly answer.

Chairman BUNNING. OK. Go ahead.

Mr. CHRISTENSEN. On that, I will tell you, Mr. Myers, you have not been in high schools recently, then, because the best thing that I have had the opportunity to do is travel to high schools. We talk about it with the seniors, juniors and sophomores, and I ask how many of them work and nearly every hand goes up. The number one issue that we talk about is Social Security.

If you haven't done this, I would encourage you to spend less time in Washington and spend more time going to the high schools and talking to the kids that are out there, that are frustrated and fed up with what is going on and totally lacking in any kind of feeling of ability to change the system.

Most of them are seeing 35 to 40 percent of their biweekly money just going in taxes and they know they are not going to see any money returned. It is very frustrating.

And then to hear you talk about, well, we ought to frankly raise the tax another 0.3 percent on both the employer and the employee, that is no solution at all. I see that as a total absence of any kind of positive answer to the solution.

I would like to hear the other three gentlemen's position on Dr. Myers' statement that says that we should not look at this as an investment and that this is purely a social issue.

Mr. BUTLER. I think it is a mix of both and should be seen as such. And just to take the analogy of Dr. Myers' about school taxes, people are concerned about school taxes and education in two ways. If they have children, they are concerned about the education of those children who belong to them. But also, if they do not have children, they are looking at education in general in the United States and what that means in terms of our productivity and our situation. They are concerned about whether their taxes are, in fact, paying for good education.

We need to be looking at Social Security in roughly the same way. It is a mixture of a system which is intended to transfer income and wealth—that is fine—and it is one to allow people to get income retirement security. And both of those have to be looked at.

The concern for so many people today, such as younger workers, and particularly male minority workers, is that while there may be redistribution, sometimes it is not even in their interest and second, that when they are looking at getting retirement income, the taxes are such that they do not have other discretionary income to put aside to supplement Social Security, and that is a real concern for those individuals.

So we have to do both with Social Security. Social Security is both an income redistribution guaranteed income system but also a means of people to save and to put money aside for their retirement. And the problem today is that that second element is failing a lot of people.

Mr. CHRISTENSEN. Dr. Butler, you and I have talked about this before, about trying to get information to these young people. One way is looking at through the Internet so that they can pull up information to find out exactly where they stand, as an 18-year-old or a 17-year-old, in terms of when they are 65, how much is built up in their account, just seeing the kind of return. Dr. Myers does not believe that the rate of return matters. How do you feel about this issue?

Mr. BUTLER. Well, I think that, as I said in my statement, that there ought to be a rate of return estimate for people to take into account. I am not saying it is the only factor that should be taken into account, but people ought to know that so that when they make decisions about their workforce participation, or the degree to which they are working, or whether their spouse enters the workforce, they at least have the information about what rate of return is available to them, to compare with alternatives.

And that, I believe, should be the case with any opt-out personal savings approach in this country. The same requirement should be placed on those plans, too, so that people can make comparisons. I think it is almost self evident that we should be doing this.

Mr. CHRISTENSEN. Dr. Mashaw.

Mr. MASHAW. Stuart and I do not disagree about this. It is a very complicated system. To look at either its tax and redistribution aspects or its pure investment aspects separately, it seems to me, makes no sense. How you communicate to people what the mix is and how they ought to think about this is a much more difficult problem.

I think looking at it in either way individually simply misleads people about what this system is about. It is ensuring against many things, including not having your parents live with you in old age and not having to live with your children in old age and not having to pay increased taxes for those people who have been improvident and do not save for their old age.

So it is a very complicated thing to get across.

Mr. CHRISTENSEN. And not to be totally negative toward you, Mr. Myers, but I do agree with you on some of the points about the retirement age. We are living longer. We need to look at that. I would applaud your efforts in that area.

Mr. MYERS. Thank you. Mr. Christensen, I might say that I have not talked to high school students. I do get outside the beltway, and I frequently talk to college students. Immodestly, I might say that I can generally convince them that the system is going to be there if it is modified in reasonable ways.

When I talk about raising the retirement age and they say, "Oh, but look, we are going to have to work until 70 and you guys could quit at 65," I point out, "Look at the lifetime aspect of it, that you will probably live longer at 70 than people do today at 65." Then they see that point.

So if you educate the younger people, have discussions with them, place all the facts before them, I think that they may come to a different conclusion.

Mr. CHRISTENSEN. And I know that you have spent a lot of time in this area, Dr. Myers, and I do appreciate your work.

I guess I am out of time.

Chairman BUNNING. Mac.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Christensen makes a very good point about talking to young people. That is one of the main things that comes up when I speak to a young group, whether it be high school or college, whether it be in Georgia or they are visiting here in Washington. And it is hard to convince them that Social Security is an investment. It is a mandatory deduction from their paychecks. They have no choice as to whether it comes out. They have no choice as to where it goes and they have no choice as to whether someone else uses or borrows those funds to keep a government running that is running at a deficit.

So it is not a bright future as far as trying to convince people that this is an investment process, because they do not see it that way.

And another interesting thing is when you ask the same question that Mr. Christensen talked about—"How many of you young people work?"—a lot of those high school students will raise their hand. You ask them what was their reaction to the first paycheck they drew, they just kind of draw up and frown and they say, "Well, the first thing I did was go ask Momma, is this right? This is not fair. Look what they took out of my check. I earned this much and I only get this much. Something's not right about this system."

So it is a very difficult challenge, and I do my best to convince them that it is going to be there because, as I tell them, as I told the President when he was in Georgia 2 years ago about this same time, that Social Security is my old age pension. I am going to say it again, Mr. President. Social Security is my old age pension because I turned down the congressional pension. My small business does not have a pension. I have an IRA and Social Security is my old age pension. His response was, "I find your background very interesting." Well, I wanted to say, "I find yours very interesting, too," but I did not go that far.

But there is a statement to be made there. Social Security is all of our old age pension because it is mandatory. It is not an investment. It is a mandatory deduction from our paychecks. It is very hard to convince these young people that it is going to be there. It is very hard to convince seniors today that it is not going to be reduced and not going to be cut.

My question to you: What is your opinion on CPI? Mr. Myers.

Mr. MYERS. I usually have a very strong opinion on almost any subject dealing with Social Security, but as to the CPI, I am rather ambivalent because the CPI, unfortunately, is not a very precise thing. What is the proper CPI for one group of people may not be for another group. For people over 65, a certain market basket might be right. For young survivors, another might be. It is just not a very precise matter.

I think that the CPI as it is now probably overstates inflation, but I would not want to venture a guess whether it ought to be 1.1 or not. But I do look at the other side of the coin—that if the overstatement were 1.1 percent, it would certainly help the long-range financing of the program when it was corrected.

Mr. COLLINS. That is good, in a much less lengthy answer.

Mr. STEUERLE. CPI is an interesting issue, among other reasons, because its principal long-run effect, if you cut back on the CPI, is to increase income tax rates. That is because the income tax is CPI adjusted, whereas Social Security actually has a wage index that is not affected by changes in the CPI.

The initial level of benefits in Social Security is not changed at all by changing the CPI. When you cut back on the CPI, you mainly affect the oldest of the elderly, cut back on their benefits.

Mr. COLLINS. Mr. Mashaw.

Mr. STEUERLE. Bottom line, as a technical matter, however, what Congress could do is cut back on the CPI by a modest amount, fully fund the BLS and count on them to do——

Mr. COLLINS. Quickly, Mr. Mashaw, and then I want to get to Mr. Butler and then I have an opinion.

Mr. MASHAW. I have exactly the same belief, that there is a correct CPI, as that I will be abducted by a UFO. [Laughter.]

Mr. COLLINS. Mr. Butler.

Mr. BUTLER. I believe that if we say to retirees, we will adjust your benefits according to your actual cost of living, that should be as accurate as we can possibly do. Therefore, I think we should be looking at ways to make that more accurate.

I do not think anybody would dispute the fact that if we people were saying the CPI is too low and that benefits should be adjusted upwards to take that into account, there is no question in my mind that Congress would be acting right now to adjust benefits.

Mr. COLLINS. The point is that people do not know what CPI means. This goes back to Mr. Myers. When you try to discuss CPI with seniors, the only thing they know is that every year their checks are adjusted to the cost of living, the increase in what it costs to buy products at the grocery store. They do know, too, that those products increase because they got an increase.

But it confuses people when you talk about CPI and that is the reason that I think we ought to stay with the terminology "the cost of living increase." And if there is going to be an adjustment, put everybody in the starting gate at the same time and address it according to the cost of living. Forget this language of CPI. It confuses people. They do not know what you are talking about, and they are afraid you are trying to hoodwink them.

Thank you, Mr. Chairman.

Chairman BUNNING. Thanks, Mac.

Congress has never adjusted the CPI, ever. The Bureau of Labor Statistics in the administration has always adjusted the CPI. So you are telling us, in your opinion, that Congress should address the CPI? Is that your personal opinion? Or do you think that it should be handled by the administration?

Mr. STEUERLE. I think, in terms of the CPI index, it has to be done by a technical staff. Part of the problem with the CPI is it is not a cost of living index, which everyone throughout the spectrum admits, from people who don't want to adjust to people who do want to adjust.

What Congress can do, as I think Mr. Collins suggested, if they want to—I don't think you can go very far because nobody knows what the right number—is to set a reasonable cost of living adjustment as the CPI minus 0.02 or 0.03. I do not think you can cut to the full extent which some people are asking because some of the adjustments they are asking BLS to do, and you——

Chairman BUNNING. No one in the Congress knows what is included in the CPI, and everything that determines the CPI, so we would be acting in complete ignorance if we tried to adjust it.

We had a group of supposed experts on the Boskin Commission telling us that 1.1 percent would be their suggestion. We had the Chairman of the Federal Reserve telling us it is anywhere between 0.5 percent and 1.5 percent, and he has a lot more statistical data than anybody in the Congress.

But the fact of the matter is that CPI issues should not be a consideration in what we are doing here, in trying to look at the long-range solvency of Social Security. The Bureau of Labor Statistics takes into consideration those things that effect the CPI.

Let me just get back to Dr. Butler for a second. I was pleased to see your comments regarding the personal income and benefit statements. I think that is a very big educational tool, as you do. I am going to give you an example, because my father used to track this when he was alive.

When he retired in 1970, he came to me and said, "Jim, I have put $3,200 into the Social Security system." Each year he tracked what he got back. When he died in 1992, he had received over $210,000 in return. Now, that is someone who started contributing at the beginning of the Social Security system, not after 1951.

So it is more of an educational tool. The sooner SSA can distribute—not on the Internet—but written statements to those who are about to receive or who already receive their benefits, the sooner they realize how much they've paid into the Social Security system and how much they are or will receive back.

People need to realize that Social Security was not designed as an investment insurance program, but it is a pay-as-you-go system. It is unlikely that an investment of $3,200 could have grown to $210,000 in a lifetime, because of the small increments that my father paid in.

So I happen to agree that if we could get that statement into every Social Security recipient's hands, it would be an important educational tool.

It would be beneficial if we could update the statement annually for those people that are currently paying into the system. People do not know that 15 percent goes in off the top from the employer and the employee. That is a substantial amount, even if you are in a very low income bracket. And the sooner we can get that information out to the general public, especially those young people who John Christensen talked about, the better off we are going to be.

Is there anything else that any of you would like to bring forth? We have your written testimony.

Mr. MASHAW. Could I comment on your last statement, Mr. Chairman?

Chairman BUNNING. Surely.

Mr. MASHAW. I think it is very important to get the information out. I think it is very important to get full disclosure out. That is, I think those statements ought also to reveal that Social Security is providing more survivors insurance, life insurance, than is written by private companies in the United States. I think, if we can estimate it, that the current value of the disability insurance that is being provided, also, ought to be there, so that people can really get a good idea of what is in this package and——

Chairman BUNNING. Well, the total, overall package.

Mr. MASHAW. Yes, and its elements.

Chairman BUNNING. Anyone else?

Mr. MYERS. Mr. Chairman, I would like to mention one thing of possible historical interest in connection with Dave Koitz' excellent testimony, to amplify on it a little—namely the situation in 1983 when the Greenspan Commission made its recommendations.

At least the technical people knew at that time that there was going to be this big buildup in the trust funds temporarily and then a reduction and eventual exhaustion. It was hoped that it would not occur nearly as early as 2029. We also knew that, at the end of the valuation period, there was this gap.

But, with the crisis that there really was at that time it was essential to get the various people with different political views to agree on a compromise package that would assure the safety of the system for at least the next 10 years and would do something about the long-range problem. So, there just wasn't time to bring up these relatively minor points, which could readily be dealt with later when there was more time, when there was this great difficulty of getting a consensus, which was done, and which the Congress then enacted.

Chairman BUNNING. Thank you all for being here. Thank you for your testimony.

The hearing is adjourned.

[Whereupon, at 12:13 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Steven Cord, Center for the Study of Economics

STEVEN B. CORD, President ALBERT S. HARTHEIMER, Vice President FRED KARN, JR., Treasurer JOSHUA VINCENT, Secretary

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STATFMENT ON SOCIAL SECURITY
by
STEVEN CORD, PRFSIDENT
CENTFR FOR THE STUDY OF ECONOMICS
2000 CENTURY PLAZA (#237), COLUMBIA MD 21044, 410-740-1177

The Social Security System is currently producing a surplus, but it will shortly be producing tremendous deficits, especially after 2012 when the federal government will have to start paying back the Social Security Trust; Fund borids with money it is not likely to have (there'll be other federal deficits). These payments could be met by either -

- Reneging on Social Security benefits, but this is politically and morally unacceptable. These benefits are already quite small.

- Higher taxes on producers - workers and businessmen - but doing this would create political and economic chaos.

- Higher federal taxes on the locational value of land (which the federal government did in 1798, 18ll and l865). This would encourage land owners to use their sites more fully (since inappropriate improvements would not generate enough revenue to pay for the higher land value tax plus a reasonable return on the improvement). If sites are more fully utilized, then jobs will be created. Here is a tax which actually benefits the economy and which should be collected even if thrown out afterward (!)

Will Americans actually institute a federal tax on locations i.e., land values? -

1) There is no other alternative to solving the coming Social Securit;y crisis. Pure desperation might lead to federal land value taxation.

2) Most people will pay less in taxes with land value taxation than with any alternative tax.

3) A federal land value tax would boom the economy. No wonder eight (8) recent American winners of the Nobel Prize in economics endorse it and it has been successful where tried.

Responsible federal politicians should start instituting a federal land value tax and educating the American public to this sole Social Security solution - now. Otherwise, many of our elderly will be eating dog food

A nonprofit educational foundation

Incentive Taxation
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SUMMARIES OF TWO-RATE PROPERTY TAX STUDIES

The Proposal - Shift the property tax on buildings to land assessments by taxing land assessments at a higher percentage rate than building assessments ("two-rate rather than one-rate").

Why Do It - (1) If buildings are taxed less, they'll be more profitable to construct and operate, also more affordable to rent or buy; and if land-sites are taxed more, they'll be developed more fully, thereby creating jobs and new construction as well as a revenue for local government (which will re-coup the property tax revenue lost by not taxing buildings so much because it will be taxing land more). (2) All tenant-voters and most homeowner-voters will pay less tax.

- **Over 700 cities** in the world are taxing buildings less than land or not at all, and ALL studies indicate good results.
- **Dozens of C.S.E. studies** show that most homeowners and all tenants pay less with a building-to-land shift in the property tax.
- **Another C.S.E. study** showed that the average property tax on buildings is equivalent to a 14.6% sales tax.
- **Pittsburgh is** now taxing land assessments at 18.45% and building assessments at only 3.2% instead of both at about 5.9%; in 1979, when it first started to jump its land tax rate more than its building tax rate, its new construction increased **293%** in the three years after the initial building-to-land switch as compared to the previous three years, whereas new office-building construction nationwide increased only **54%**.
- **New Castle, Pa.'s** building-permits issued jumped +**70%** in the three-year period after it shifted some of its property tax from buildings to land, whereas neighboring and comparable Farrell experienced a **-66%** decline, and neighboring and comparable Sharon experienced a **-90%** decline during the same time periods.
- **McKeesport, Pa.** likewise out-constructed its neighboring and comparable cities of Duquesne **+38%** to **-20%** and Clairton by **+38%** to **-28%**.
- **Scranton, Pa.** likewise out-constructed neighboring and comparable Wilkes-Barre by **+23%** to **-47%.**
- **Clairton, Pa.** likewise exceeded the national average for new construction after its building-to-land tax shift (**+8.5%** to **-5.8%**).
- **Aliquippa** likewise experienced a +97% increase after its building-to-land property-tax shift; neighboring but better situated Ambridge and Beaver Falls experienced declines.
- **Victoria, Australia**: 24 cities in this state switched from taxing land and buildings to taxing land only; they ALL experienced a construction spurt exceeding that of their statistical district.
- **Sydney, Australia** (3.7 million population) uses land value taxation successfully, according to Urban Land Institute research monograph #19.
- **Many more studies** indicate that if buildings are un-taxed, they will be more affordable and profitable-to-construct, and when land assessments are up-taxed, sites are used more efficiently, thereby creating jobs and new construction.

November 1991

Incentive Taxation

Seven Nobel Prize Winners Endorse Land Value Taxation

The headline is correct. If we had eight, would you be more impressed, and even more important, moved to action?

Milton Friedman: "I share your view that taxes would be best placed on the land, and not on improvements."

Herbert Simon: "Assuming that a tax increase is necessary, it is clearly preferable to impose the additional cost on land by increasing the land tax, rather than to increase the wage tax - the two alternatives open to the City (of Pittsburgh). It is the use and occupancy of property that creates the need for the municipal services that appear as the largest item in the budget - fire and police protection, waste removal, and public works. The average increase in tax bills of city residents will be about twice as great with wage tax increase than with a land tax increase."

Paul Samuelson: "Pure land rent is in the nature of a 'surplus' which can be taxed heavily without distorting production incentives or efficiency." A land value tax can be called "the useful tax on measured land surplus."

James Tobin: "I think in principle it's a good idea to tax unimproved land, and particularly capital gains (windfalls) on it. Theory says we should try to tax items with zero or low elasticity, and those include sites."

James Buchanan: "The landowner who withdraws land from productive use to a purely private use should be required to pay higher, not lower, taxes."

Franco Modigliani: "It is important that the rent of land be retained as a source of government revenue. Some persons who could make excellent use of land would be unable to raise money for the purchase price. Collecting rent annually provides access to land for persons with limited access to credit."

Robert Solow: "Users of land should not be allowed to acquire rights of indefinite duration for single payments. For efficiency, for adequate revenue and for justice, every user of land should be required to make an annual payment to the local government equal to the current rental value of the land that he or she prevents others from using."

The current president-elect of the American Economics Association, **William Vickrey,** also endorses land value taxation: "It guarantees that no one dispossesses felllow citizens by obtaining a disproportionate share of what nature provides for humanity."

The endorsements from the last three economists named above were taken from a letter dated November 7, 1990 to Mikhail Gorbachev signed by 30 prominent U.S. economists.

Statement of Kelly A. Olsen, Employee Benefit Research Institute

It is a pleasure to submit material for the printed record of the hearing held by the Committee on Ways and Means, Subcommittee on Social Security, on March 6, 1997 entitled, "The Future of Social Security for this Generation and the Next." My name is Kelly Olsen, and I am a research analyst at the Employee Benefit Research Institute (EBRI). On behalf of Dallas Salisbury, President and CEO of EBRI, I would like to inform you of the pioneering effort that EBRI is making through its Social Security Reform Evaluation Project to ensure that the future of Social Security is based on the type of accurate, complete information required for sound policy decision-making.

THE EBRI SOCIAL SECURITY REFORM EVALUATION PROJECT

Both because of the complexity of Social Security and the emotion evoked by widespread consensus that the program is in need of reform, the availability of clear, objective, nonpartisan analysis of policy alternatives is essential. The desire to provide this type of analysis as well as the tools for further analysis is the impetus behind the Employee Benefit Research Institute's Social Security Reform Evaluation Project. At the heart of this effort lies the development of the EBRI–SSASIM2 Policy Simulation Model, the type of model ("stochastic") recommended for development by a majority of Council members in the 1994 1996 Social Security Advisory Council report.[1]

Although the EBRI–SSASIM2 Policy Simulation Model is central to the overall project, EBRI's educational efforts go beyond the sole provision of quantitative tools and analysis. As evidenced in the January 1997 EBRI Special Report, "Keeping Track of Social Security Reforms," which profiles seven popular reform plans, EBRI is committed to helping policymakers and the public compare and understand the current reform proposals. In addition, the March 1997 EBRI Issue Brief, "A Framework for Analyzing and Comparing Social Security Policies," explores eleven areas of consideration under which current law and proposed reforms must be examined to ensure fair, objective, and comprehensive analysis and comparison among policy alternatives. These recent publications build on over a decade of previous EBRI research on Social Security issues.

THE NEED FOR THE EBRI–SSASIM2 POLICY SIMULATION MODEL

There are several reasons why the availability of a model like EBRI–SSASIM2 the only one of its kind is especially critical to the quality of this round of Social Security debate. First, while policy simulation modeling has a long tradition in the Social Security policy analysis community, most current models are designed to analyze the nonstructural reforms that have dominated past debate (e.g., raising taxes, cutting benefits). As a result, most current models are not well suited to analyzing more fundamental Social Security reforms, such as the implementation of individual accounts or the shift of trust fund assets into equities. In addition, the EBRI–SSASIM2 model will allow for more realistic modeling than was previously available of the range of outcomes that could result under the current system, if it remains unchanged. This will provide a better understanding of the current system as a baseline by which to compare reforms.

CAPABILITIES OF THE MODEL

EBRI–SSASIM2 began as the SSASIM model, which was created under contract with the 1994 96 Social Security Advisory Council to analyze the effect of a partial switch of trust fund investments into equities. Since then, EBRI has contracted to expand the model's capabilities. One of the added analytic capabilities is the ability to analyze the effects of implementing individual savings accounts either to augment or replace the current Social Security system. For this purpose, assumptions about rates of return on equities and individual investment behaviors are necessary. Unlike other models, which often "hard wire" their assumptions, EBRI–SSASIM2 allows the user to select his or her own assumptions about equity returns and investment behaviors, as well as assumptions about several other variables such as tax rates, the cost-of-living formula, and mortality and birth rates. In addition, the user can model varying mixes of individual accounts and the traditional defined benefit Social Security system in order to assess outcomes under a partially "privatized" system.

A second added capacity is EBRI–SSASIM2's ability to "permit policy analysis to be conducted in a way that more realistically incorporates uncertainty into its measures of long-term financial viability."[2] Because Social Security models project policy outcomes based on uncertain events and circumstances such as stock market performance in 20 years, or birth rates in 40 years it is important that such uncertainty be reflected in modeling results. This uncertainty is not expressed in the traditional high, low, and intermediate point estimates used by the Social Security Administration (SSA) and can only be expressed with the use of "stochastic" modeling techniques. While the SSA's traditional techniques can report outcome estimates under pessimistic, optimistic, and intermediate scenarios, such results do not give an indication of which scenario is actually most likely to occur. In addition, unlike

[1] Advisory Council on Social Security, Report of the 1994–96 Advisory Council on Social Security, Vol. 1 (Washington, DC, 1997), p. 22.
[2] Ibid.

stochastic methods, traditional point estimates cannot express the range of likely outcomes. For example, a point estimate under intermediate assumptions might, report a 6 percent real rate of return on equities over the next 75 years. In contrast, stochastic modeling might show that under the same assumptions, there is an 80 percent chance that equities will range from 5–7 percent real return in the next 75 years.

A third added capability of the EBRI–SSASIM2 model over the original SSASIM model is the ability to analyze Social Security's macroeconomic effects. As a program that covers 141 million workers and holds over half a trillion dollars in reserves, Social Security is a significant force in the U.S. economy. For example, a change in normal retirement age could impact the labor market; a change in trust fund investment could affect financial markets; and the addition of individual savings accounts could increase personal savings rates and thereby spur economic growth by providing more investment capital. The interaction of multiple outcome variables can produce primary and secondary economic feedback effects effects of which the policy community might not be aware or be able only to speculate about without a macroeconomic feedback model pertaining specifically to Social Security policy. For this reason, EBRI–SSASIM2 includes savings, investment, and productivity growth linkages that permit analysis of the extent to which Social Security policy affects national saving, capital accumulation, and hence, productivity growth.

With model completion scheduled for the summer of 1997, EBRI–SSASIM2 will be able to generate several outcome variables. Model results of reform options [3] and the current system will include the following benefit and cost measures:

- Lifetime Program Benefits: Actuarial present value of lifetime program benefits (adjusted for inflation and mortality).
- Benefit-Contribution Ratio: Actuarial present value of lifetime program benefits divided by the actuarial present value of lifetime payroll contributions.
- Net Benefits: Difference between actuarial present value of lifetime program benefits and the actuarial present value of lifetime payroll contributions.
- Net Benefits as a Percentage of Earnings: Net benefits minus contributions, divided by the actuarial present value of lifetime earnings.
- Internal Rate of Return: Internal rate of return on benefits given contributions.
- Average Benefit: Average annual real benefit over retirement years.
- Replacement Rate: Percentage of final year of preretirement earnings that is replaced by the average benefit for a continuously employed person earning average wages.
- Low Benefit Avoidance: Percentage of beneficiaries expected to have retirement benefits above a low-benefit threshold.
- Real Per Capita Gross Domestic Product (GDP): Inflation-adjusted value of the GDP.
- Average Cost Expressed as a Percentage of Taxable Payroll
- Actuarial Balance Expressed as a Percentage of Taxable Payroll

EBRI–SSASIM2 will allow these benefits and cost measures to be reported in aggregate for entire age cohorts and for individuals with different demographic characteristics within these cohorts by using realistic age-earnings profiles. In addition, users of the EBRI-SSASIM2 Policy Simulation Model will be able to create their own "stylized" individuals by defining age, earnings, asset allocation, and annuitization behavior in order to generate programmatic outcome data for specific groups.

EBRI'S ROLE IN THE SOCIAL SECURITY REFORM DEBATE: PROVIDER OF NONPARTISAN EDUCATION AND RESEARCH

In short, EBRI–SSASIM2 will generate aggregate and individualized quantitative analysis about the current system and proposed reforms, using the most up-to-date technology in policy simulation, as recommended by the 1994 96 Social Security Advisory Council. Designed to allow the user to employ his or her own assumptions and beliefs in the model, and to model various structural policy alternatives, EBRI–SSASIM2 is nonpartisan in design and is the centerpiece of EBRI's overall effort to provide nonpartisan guidance and information. Social Security is an issue whose complexity and importance exposes it to the risk of misunderstanding and demagoguery. As a neutral voice in the whirlwind of advocates for one side of reform or another, EBRI is providing tools and analysis for informed policy decision-making.

[3] The first actual reform plans to be modeled will be the three Advisory Council plans.

KENTUCKY TEACHERS'
RETIREMENT SYSTEM
March 18, 1997

The Honorable Jim Bunning, Chairman
Subcommittee on Social Security
Committee on Way and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: March 6, 1997

Dear Mr. Bunning:

I am writing to express the strong opposition of the Teachers' Retirement System to any attempts to mandate Social Security coverage for Kentucky's public school teachers. My statements speak solely on behalf of the 58,000 members of the retirement system. I represent no individuals or groups beyond the members of the Teachers' Retirement System.

The issue of mandatory Social Security coverage for teachers and other state and local public employees, as you are well aware, has been proposed on several occasions during the past 20 years.

The Kentucky General Assembly enacted legislation in 1938 establishing the Teachers' Retirement System (TRS). This legislation was a direct result of the federal government prohibiting public employees from participating in the Social Security System. After almost 60 years of operation, the TRS is proud to have a defined benefit plan operating on an actuarially sound basis as attested to by the annual valuation conducted by the System's actuary.

The TRS is an "actuarial reserve, joint contributory" plan. The member and state contributions plus earned interest are placed in reserve to meet the annuity obligations of the members. If member benefits are improved, the contribution rate is increased to finance the improvement. This is an important difference from Social Security that has operated on a "pay as you go" basis.

Unlike Social Security, many state retirement programs have constitutional or statutory provisions that guarantee promised benefit coverage. Kentucky has a statutory provision that constitutes an inviolable contract which prevents the reduction or impairment of member benefits. Eligibility requirements or benefits for members are not altered and the members are well aware that they and their survivors will not have promised benefits withdrawn by future legislation.

The 1977 federal legislation which became effective in the early 1980s, known as the Social Security Offset Provision, is a good example of promised benefits being withdrawn. A reduction in benefits for eligible spouses may well have been justified, but the offset provision should not have been applied to Social Security participants who had earned the spouse protection prior to the enactment of the law. Certainly, there is no inviolable contract for Social Security participants.

Kentucky teachers contribute 9.855% of their salary toward retirement and the state provides 13.105% of each employee's salary. To add Social Security on top of these amounts would not be fiscally possible. The net result would be to reduce benefits under a very sound plan in order to accommodate Social Security. Kentucky very clearly does not want to water down its benefits for its career teachers. It is the one benefit that teachers are very proud of and grateful for when their careers are completed. Even if the proposal would only include new hires, it would only be a very few years before the costs would escalate drastically related to mandatory coverage.

State and local governments would have to assume the additional financial burden for mandatory coverage along with the employees. Mandatory coverage amounts to nothing more than a new tax being imposed on state and local governments and the employees of those subdivisions who have provided fiscally sound retirement plans over the years. Public retirement systems, including the Teachers' Retirement System, have built their reputations on providing promised benefits at reasonable costs to the membership. The package of benefits provided by these systems, including the Teachers' Retirement System, surpass the benefits provided under Social Security in almost all cases.

Funds now provided by the retirement system for investment capital could well be impaired. Enactment of mandatory Social Security coverage would certainly reduce the available funds for capital improvement. The Kentucky Teachers' Retirement System has assets of over $8 billion and if members are required to pay for Social Security, a reduction will have to be made in the retirement contributions of the members. The funds diverted to Social Security will not likely be used for capital investment in the private sector.

On behalf of the Board of Trustees of the Kentucky Teachers' Retirement System, I ask you and each member of your subcommittee to reject the idea of mandatory Social Security coverage.

Sincerely,

PAT N. MILLER
Executive Secretary

Statement of Laurence J. Kotlikoff, Professor of Economics, Boston University; and Jeffrey D. Sachs, Professor of Economics, Harvard University

INTRODUCTION

Chairman Bunning and other distinguished members of the Subcommittee on Social Security of the Committee on Ways and Means,

The U.S. Social Security System is in urgent need of reform. It has a massive long-term deficit that cannot be covered without major payroll tax hikes or significant benefit cuts. The system is also inefficient, inequitable, uninformative, and outmoded.

The Personal Security System would redress these problems by replacing the OAI portion of Social Security with a system of individual accounts and by establishing a dedicated stream of revenues to pay off the current system's unfunded liability.

Unlike most other plans being put forward, this plan has a real means of financing the transition, protects non working spouses, protects survivors, delivers true progressivity, and ensures the annuitization of personal security account balances in old age.

The Personal Security System, is being endorsed by a growing number of academic economists including three Nobel Laureates in Economics: Robert Lucas of the University of Chicago, Merton Miller of the University of Chicago, and Douglas North of Stanford University.

The Personal Security System has seven elements:

• Social Security's Old Age Insurance (OAI) payroll tax is eliminated and replaced with equivalent contributions to PSS accounts.
• Workers' PSS contributions are shared 50–50 with their spouses.
• The government matches PSS contributions on a progressive basis.
• PSS balances are invested in a regulated, supervised, and diversified manner.
• Current retirees and current workers receive their full accrued Social Security Retirement benefits.
• A Federal retail sales tax finances Social Security retirement benefits during the transition and the PSS contribution match.
• At age 65, PSS balances are annuitized on a cohort-specific and inflation-protected basis.

Simulations of this approach to social security reform show substantial long-run improvements in U.S. living standards. These gains reflect the partial alleviation of the enormous fiscal burden facing future generations arising from current entitlement programs. Precise analysis of any social security reform requires the use of the Social Security Administration's extensive data bases. For this reason, we strongly urge Congress to instruct the Social Security Administration to provide a detailed analysis of this proposal.

SCOPE OF THE PROPOSAL

Only the OAI payroll tax (about 70 percent of total OASDI contributions) is eliminated. Contributions made to and benefits received from the DI (Disability Insurance) and SI (Survivors Insurance) portions of the Social Security System are completely unchanged.

Earnings Sharing

To protect non-working spouses as well as spouses who are secondary earners, total PSS contributions made by married couples are split 50–50 between the husband and wife before being deposited in their own PSS accounts.

Government Matching of PSS Contributions

The federal government would match PSS contributions of low-income contributors on a progressive basis. It would also make PSS contributions through age 65 on behalf of disabled workers.

Tax Treatment of PSS Accounts

PSS contributions are subject to the same tax treatment as current 401k accounts. Contributions are deductible and withdraws are taxable.

Survivor Provisions of PSS Accounts

Through age 65, survivor provisions governing PSS balances are identical to those governing 401k accounts.

Investment of PSS Account Balances

Workers and their spouses invest their PSS contributions in regulated, supervised, and diversified investments. For example, these investments might be restricted to inflation-indexed, exchange-rate hedged, high-grade domestic and international government and corporate zero-coupon bonds which come due when the worker reaches age 65. Alternatively, the portfolio rules could specify particular equity and debt shares that might vary by age, but which preclude trying to "time the market."

Annuitization of PSS Account Balances

PSS balances can not be withdrawn prior to age 65. At age 65, PSS balances are pooled with those of other cohort members. The federal government purchases, on a competitive fee-bidding process, single-life, real annuities for each cohort member in proportion to his or her age 65 PSS account balance.

Payment of Social Security Retirement Benefits to Current Retirees

Current recipients of Social Security retirement benefits continue to receive their full inflation-indexed benefits.

Payment of Accrued Social Security Retirement Benefits to Current Workers

When they reach retirement, workers receive the full amount of Social Security retirement benefits that they had accrued as of the time of the reform. These benefits are calculated by filling in zeros in the OAI earnings records of all Social Security participants for years after the transition begins. Since new workers joining the workforce will have only zeros entered in their OAI earnings histories, new workers will receive no OAI benefits in retirement. This ensures that over a transition period aggregate Social Security retirement benefits will decline to zero.

Financing the Transition

During the transition, Social Security retirement benefits will be financed by a federal retail sales tax. The tax would be collected by the states. The PSS sales tax would also finance the government's PSS contribution match. Over time, the PSS tax rate would decline as the amount of Social Security retirement benefits decline. Provisional calculations suggest that the sales tax would begin below 10 percent and would decline to a permanent level of roughly 2 percent within 40 years.

Advantages of the Reform

The Personal Security System would improve benefit-tax linkage, enhance survivor protection, equalize treatment of one-and two-earner couples, offset the ongoing transfer of resources from the young to the old, provide better divorce protection to non working spouses, make the system's progressivity apparent, resolve Social

Security's long-term funding problem, and ensure Americans an adequate level of retirement income.

Macroeconomic Effects

Simulation studies suggest that this reform will, over time, increase the economy's capital stock by roughly one third and its output by roughly 10 percent.

Impact on the Poor

Social Security's cost of living adjustment insulates its beneficiaries from the potential increase in consumer prices associated with the introduction of the PSS retail sales tax. Hence, the current poor elderly will experience no higher fiscal burden. Moreover, simulation analyses show that poor members of current middle aged generations, poor members of current young generations, and poor members of future generations have the most to gain from privatizing social security.

Intergenerational Equity

The PSS proposal asks current Americans, old and young alike, to contribute to paying off Social Security's unfunded retirement benefit liability. Since it insulates the current poor elderly, only rich and middle class elderly face a higher fiscal burden. Asking them to pay their share of Social Security's unfunded liability is intergenerationally equitable particularly given the massive and growing Medicare-financing burden facing future generations.

Comparision with Other Reform Proposals

Unlike many other social security reform proposals, the Personal Security System would substantially alleviate the long-run fiscal crisis facing future generations. It would also improve economic efficiency by linking retirement income to retirement saving without sacrificing secondary earners and the poor.

The Challenge Facing the Congress

All major social security reform proposals as well as the current system need to be compared on a systematic basis with respect to intergenerational burdens, fiscal sustainability, economic efficiency, and intragenerational equity. Congress should instruct the Social Security Administration to perform this analysis in consultation with the Congressional Budget Office and other agencies of the U.S. government.

Statement of National Silver Haired Congress

Mr. Chairman: The National Silver Haired Congress (NSHC) commends you and the Members of this Subcommittee for conducting this important hearing on the future of Social Security. We are pleased to share with you information on a resolution which was adopted at our Inaugural Session, February 8–14, 1997 in Washington, D.C., dealing with Social Security, its present and its future. This was, in fact, the top resolution of our Conference, modeling the outcome of the 1995 White House Conference on Aging which adopted a comprehensive Social Security resolution and it was the top vote getter of the 45 resolutions.

This resolution was adopted overwhelmingly by nearly 300 Silver Senators and Silver Representatives from 43 states, including Nelda Barnett from Owensboro, KY and Edna Hawkins from Bowling Green, KY.

Its main points include:

- Exclude Social Security from any Federal balanced budget amendment or law.
- Ensure Social Security trust funds and contributions shall not be diverted into individual private accounts.
- See that Social Security shall not be means tested.
- Maintain a COLA computed by the Bureau of Labor Statistics to be distributed in January of each year, to include military, railroad and civil service.
- Mandate income from married couples shall be divided in order to establish equal and separate accounts.
- Eliminate restrictions on earnings after retirement for Social Security purposes.
- Create and support a strong program to inform the public about Social Security.

• Assure that all new state and local government employees hired after 1997 must be brought under the Social Security system resulting in increased payroll taxes for the system.

The NSHC hopes that our resolution contributes to the discussion and subsequent actions taken to address Social Security. We also especially commend you on approaching this issue from an intergenerational approach.

By means of background, the NSHC is a non-partisan, non-profit organization comprised of registered voters over 60 years of age from across the nation. For further information about the history of the NSHC, please see the attached information sheet.

Statement of OPPOSE

My name is Robert J. Scott. I am Secretary/Treasurer of OPPOSE. OPPOSE is a Colorado Corporation formed by teachers, fire fighters, police officers, and other state and local government employees who have elected not to join the Social Security-Medicare system. The purpose of our organization is to assure the continued financial integrity of our members' retirement and health insurance plans by resisting efforts to mandate Social Security or Medicare coverage of public employees. Our members are found in Alaska, California, Colorado, Connecticut, Illinois, Kentucky, Louisiana, Massachusetts, Minnesota, Nevada, Ohio, and Texas. With respect to the issue of mandatory Social Security and Medicare coverage, the interests of OPPOSE are identical to those of the approximately five million public employees throughout the nation who remain outside the Social Security system.

BACKGROUND

For many years after the Social Security system was created, state and local government employees were not allowed to participate in the system; Beginning in the 1950s, state and local government employers could elect to have their employees covered. Governments which elected in were also permitted to opt out again, after notification of the intent to do so, and the expiration of a two year waiting period.

This was the law for about three decades, until, in 1983, there was a major revision of the Social Security and Medicare laws, triggered primarily by a concern about the long term solvency of these two trust funds. Congress decided not to require state and local employees who were outside the system to be covered, but did end the opt out for public employees who had chosen to be covered. An "anti-windfall" rule was adopted, to ensure that public employees who were covered by Social Security and by a public plan did not receive excess credit for Social Security purposes.

In 1986, as part of the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), Congress determined to require participation in the Medicare system on a "new Hires" basis, but chose to leave public employee retirement plans in place, and did not change the law with respect to Social Security.

In 1990, Congress enacted a law requiring that all public employees not covered by a state or local retirement plan meeting specified standards must be covered by Social Security. That law, adopted as part of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"), ensures that all public employees will be covered either under Social Security or under a public retirement plan which provides comparable benefits. Today, about one-third of all state and local government employees, about five million people, are outside the Social Security system because they are covered by public retirement plans.

BACKGROUND OF THIS HEARING

There is no serious question about the soundness of the Social Security system over the next twenty to twenty-five years. The most current estimates are that income from Old-Age, Survivors and Disability Insurance ("OASDI") taxes will exceed OASDI expenditures until the year 2012. After that year, OASDI taxes, plus reasonable interest earnings on those taxes will exceed OASDI payments through the year 2019. OASDI Trust Fund reserves will continue to fund benefits through the year 2029. After that time, Social Security, viewed in isolation from all other federal programs, is projected to be in deficit.

Reasonable people differ about the date after which serious trouble really begins for the Social Security system. Although nominally established like a funded pension system, in practice, Socail Security Trust Fund surpluses are used to reduce operating deficits in other parts of the federal budget. There is an obligation for the Treasury to repay these "borrowings" from Social Security, but the federal government will not be able to repay these borrowings when the time comes, except by creating surpluses in other parts of its budget, or by printing money.

In this sense, at least, it does not matter very much if the Social Security Trust Fund is in a state of surplus. When Social Security outlays begin to exceed Social Security revenues, an additional burden will be placed on an already strained federal budget, as Social Security becomes a net importer of general federal revenues. On the other hand, if general federal revenues are in a healthy posture (admittedly an unlikely prospect), a Social Security deficit could, in theory, be little more than an accounting inconvenience.

This is not to suggest that the worrisome mid-term Social Security projections do not matter. These projections are important because they indicate that we are currently promising to future Social Security recipients substantially more than we will comfortably be able to pay.

As a result of these concerns, Social Security reform has been the subject of numerous bills and hearings, as well as several major study commissions, over the last several years.

In 1994, the Bipartisan Commission on Entitlement and Tax Reform (also known as "the Kerrey-Danforth Commission") studied the problem of projected short falls in the Social Security and Medicare Trust Funds, as well as other mid-term and long-term deficit problems. The Commission was unable to agree on a set of recommendations, but did valuable work in assessing the dimensions of the problem. In an interim report published in August, 1994, the Commission projected that with no changes in law, by 2010 entitlement spending and interest on the national debt would consume almost the entire federal revenues; by 2020, entitlement spending alone would almost equal the federal revenue stream; by 2030, there would not be enough revenue to service the federal entitlement obligations, even if no money were used for other purposes, including payment of interest on the national debt.

In 1995 and 1996, the Advisory Council on Social Security examined the mid-term and long-term solvency of Social Security and the Social Security Trust Fund. Once again, there was no majority on the Council for any set of recommendations. Three different alternative proposals were put forth by different groups of members. These hearings were held, in part, to review the Report of the Advisory Council on Social Security, and to consider those sets of recommendations, as well as other possible alternatives to reform the Social Security System.

MANDATORY SOCIAL SECURITY COVERAGE IS WRONG AND SHOULD NOT BE ADOPTED

I. Public employees are able to decide for themselves what is in their own best interest.

Of the arguments advanced for mandatory coverage, by far the most arrogant is that Social Security coverage would benefit the people affected. For example, a majority of the Advisory Council on Social Security ("the Council") suggest that "workers would generally gain" from Social Security coverage (Council report, p. 20, three members dissenting).

It is insulting to suggest that Advisory Council members, or other Washington officials, care more about, or better understand what is best for, public employees, than do the employees themselves, or their (largely elected) plan trustees.

Analyses done by public plan fiduciaries indicate that public employees of almost any description (in terms of salary, length or service, etc.) do better under their public plan than they would do under Social Security. For example, the Public Employee Retirement Association ("PERA") of Colorado produced a study (assuming retirement in 1994 at age 62) showing that an employee working ten years with a highest average salary of $15,000 per year, would receive a Social Security benefit equal to 21.6 percent of pay; the PERA employee would receive a benefit of 22 percent. For short term employees with higher average rates of pay, Social Security benefits are proportionally much lower. For example, a ten year employee with an average rate of pay of $60,000 per year would get a benefit of 10.9 percent under Social Security; his PERA benefit would be 22 percent.

Longer term employees at all rates of pay do proportionately much better under PERA. A fifteen year employee earning a high average salary of $15,000 would receive 26.1 percent of pay under Social Security—33 percent under PERA. A twenty year $15,000 per year employee would receive 29.5 percent of pay under Social Security—fifty percent of pay under PERA. At 30 years of service, this hypothetical, relatively low pay ($15,000 per year) employee would receive 36.3 percent of pay under Social Security, but 65 percent of pay under PERA. At forty years of service, the respective numbers are 39.1 percent of pay for Social Security, 80 percent for PERA.

Employees at higher rates of pay do even better. For instance, a thirty year employee with high average pay of $45,000 per year, receives a benefit of 22.5 percent from Social Security, but 65 percent from PERA.

To restate what is demonstrated by this analysis, those employees who are relatively disadvantaged, i.e., relatively low pay and relatively short term service, DO BETTER UNDER PERA THAN THEY DO UNDER SOCIAL SECURITY. Those employees with higher rates of pay do much better.

PERA of Colorado is a good plan. But analyses of other public plans suggest that these plans also provide benefits for their employees that are generally better than Social Security benefits.

The point, however, is not to prove that public plans are better than Social Security. The point is that government employees and their fiduciaries are quite capable of comparing their plans with Social Security and deciding for themselves what is better for them.

The Council argues at pages 19–20 of its report that "over the course of a lifetime, it is impossible to tell who will and who will not need [Social Security] coverage." The Council suggests that Social Security may be superior to state or local plans because of the inflation proof aspect of Social Security, or because of the spousal benefit.

Although Social Security does have some desirable features, State and local plans are often superior in terms of their ancillary provisions. For instance, state and local plans provide 100 percent immediate vesting in employee contributions. PERA of Colorado members are fully vested for a future retirement benefit percent after five years of service. By contrast, Social Security provides no retirement benefits until the employee has ten years of service.

Public plan benefits are generally guaranteed by state law, often by state Constitution. Social Security benefits and taxes may be changed by Act of Congress, and probably will be changed in ways making the system less desirable for participants in order to solve the funding problems of the system.

Public plans are funded, often fully funded. Social Security is not.

Social Security is highly portable, but so are public plan benefits. Not only are benefits generally fully transferable within the same state system, but many public plans have a buy in feature. For instance, credits earned in a Colorado plan may be used to buy in Illinois plan benefits if a teacher moves to Illinois.

Public plans may have lower retirement ages than Social Security, and generally do not penalize a retired employee who continues to work. Social Security reduces retirement benefits based upon an "earnings" test.

Although state and local plans are not required to provide survivor and disability benefits, most major plans do. These benefits are sometimes superior to the benefits provided under Social Security.

Social Security benefits are protected against inflation, although the correct amount of the inflation adjustment (CPI) is now the subject of serious debate. State and local plans often, though not always, have an inflation protection feature, either directly, or through increases in benefits provided by the legislature, and made possible by good plan management. In any event, the basic benefit provided by state and local plans is often so superior to the Social Security benefit, that Social Security's inflation protection merely serves to reduce this difference.

It may well be the case that some workers or their families will turn out to better off under Social Security than under a weak state or local public plan. But what about the overwhelming majority of workers who will be far better off under their public plan? Does the interest of this vast majority count for nothing?

Even if it were once the case that some government workers might have been better off under Social Security than under their government plan, Congress has addressed this issue. In 1990 (as discussed above), Congress enacted a law requiring that all public employees not covered by a state or local retirement plan meeting specified standards must be covered by Social Security. That provision of the 1990 Act ensures that all public employees will be covered either under Social Security or under a public retirement plan which provides comparable benefits.

Regulations issued under that law require that the state or local plan must provide a minimum benefit, generally equivalent to the benefit provided by Social Security. Special protections, having the general effect of increasing portability, are provided for certain categories of workers, such as temporary, seasonal, and part-time workers. Still other regulations protect workers from losing benefits.

If government workers want to participate in the Social Security system they can, by arranging for their government employer to contract into the system. But the decision should be made by the people affected—state and local government employees.

II. Mandatory Social Security coverage of middle class public employees now outside of the Social Security system will not improve the fiscal soundness of the system.

For the next fifteen years, the retirement portion of the OASDI Trust Fund is in good shape. As discussed above, responsible analysts believe there is reason for concern about the out years, although there is some disagreement as to exactly when the really serious problems will begin.

Most people agree that it would be wise to take action in the near future to bring the OASDI Trust Fund into long term balance. The sooner we take action, the less painful the corrective measures will have to be. Politically, however, this means a trade off of short term pain for long term gain—always a difficult proposition.

In order to understand what we need to do to correct our long term problem, it is necessary to understand why we are in our present fix. The primary reason is that we are trying to do two contradictory things with OASDI taxes.

Current OASDI taxes are higher than they need to be to fund current OASDI benefits. The theory is that we are building up a trust fund to pay future benefits.

But the theory does not correspond with what we are actually doing with the OASDI revenues. These revenues are being used to pay the current operating expenses of the United States government.

Of course, the OASDI Trust Fund receives promises to pay from the federal government, but these promises are are secured only by the future taxing power of the government. This means that at some point in the future, when the ratio of taxes to benefits is less favorable than it is today, there will be no assets to draw down in order to make up the difference.

Mandatory Social Security coverage for government employees will not solve these problems. In the short run, taxes from the newly covered government workers would exceed benefits paid to those workers. But OASDI does not have a short term problem. Short term excess revenues cannot help solve a mid-term or long term problem unless those revenues are saved and invested. But OASDI has a mid-term and long-term problem precisely because excess revenues taken in today are not being saved and invested to pay the accruing liabilities attributable to those revenues.

Fifteen, twenty, and twenty-five years out, the newly covered government employees would be entitled to the same benefits as all other covered workers. If the cost of providing benefits exceeds the funding necessary to provide those benefits (as appears to be the case today), adding more people to the system will make matters worse, not better. If the tax revenues from the newly covered government workers are not saved, mandatory coverage of public employees will result in a situation where the eventual gap between current OASDI taxes and current OASDI obligations will be far worse than it otherwise would have been.

There are other reasons why mandatory Social Security coverage will not help to solve the financing problems of the Social Security system. The Bipartisan Commission on Entitlement and Tax Reform worked long and hard analyzing various options to ease the entitlement and deficit problems which our nation will confront in the next century. The Commission was not able to reach a consensus on recommended action. Co-Chairmen Danforth and Kerrey did present a package of options, one of which was mandatory Social Security. It was estimated that mandatory Social Security would only achieve about 1.8 percent of the Commission's entitlements objective (about ten percent of its Social Security objective). (The Advisory Council on Social Security had a similar estimate with regard to Social Security needs.)

This 1.8 percent estimate, however, is almost surely inflated. Under present law, annuities from public pension plans are fully taxable to the extent that those benefits exceed the beneficiary's own after tax contributions to his or her retirement plan. Social Security benefits are not taxable to most recipients, and most retired public employees would fall below the income threshold for taxation of Social Security benefits. The resulting loss to the general revenue fund may easily offset any very modest gain made by the Social Security Trust Fund.

Moreover, to the extent that mandatory coverage imposed new burdens on the states, states would be forced to raise taxes or reduce services to offset their increased obligations. New state taxes would be deductible, thereby further reducing general fund revenues.

Finally, estimates of gains to the Social Security Trust Fund from mandatory coverage must be predicated on the assumption that other changes in law are made which have the general effect of reducing the current highly favorable pay back ratio which most Social Security beneficiaries receive. It is obvious that if Social Security loses money on a per participant basis, adding more participants will not help.

III. Mandatory Social Security coverage would not be fair.

The Advisory Council on Social Security argues, at page 19 of its report (three members dissenting), that "all Americans have an obligation to participate [in Social Security], since an effective Social Security program helps to reduce public costs for relief and assistance, which, in turn, means lower general taxes."

One of several confusions in this argument is the failure of the Council to notice that public retirement plans also reduce public costs for relief and assistance in precisely the same way that Social Security achieves this effect. Employees covered by public plans are not candidates for welfare, SSI, or other forms of public assistance.

For most public employees, their rights in their retirement plan represent a substantial part of their life time savings. In 1989, the median American household had a net worth of approximately $42,000, much of this tied up in their equity in their home. Forty-two thousand dollars is not a large cushion. For middle income public employees, the security provided by their public retirement plan makes possible a comfortable, reasonably secure life.

There is also no exposure to the federal government, or the taxpayers who support that government, in connection with public plans, because public plans are not insured by the Pension Benefit Guaranty Corporation.

There is every reason to believe that mandatory Social Security coverage would impair retirement security for millions of public employees. State and local government plans work well for employees because public fund assets are invested in the economy, and returns on those investments allow the employees to receive substantially greater benefits than would be possible under a pay-as-go-approach. Although some people would argue that the Social Security Trust Fund is also invested, these monies are invested solely in government accounts, and the benefits are secured only by the future taxing power of the United States government.

Mandatory Social Security, even on a new hires basis, would undercut the ability of state and local governments to maintain their plans. Some government employers might attempt to maintain a two tier system divided along the lines of existing employees (remaining in their public plan) and new hires (covered by Social Security and a supplemental public plan, or, possibly, no plan), but cost and administrative considerations would almost certainly defeat this effort within a short time. In any event, a supplemental state plan, on top of Social Security, would almost certainly be far less generous than existing plans, because the out flow of cash to Social Security would not be invested.

This undercutting of existing plans would be nothing less than a breach of faith, because many public employees accept less than competitive wages in part because they know that the public retirement plan will take care of them later.

CBO has recognized this point in its report entitled "Reducing Entitlement Spending" (page 18) where, in the context of discussing the inappropriateness of lumping federal pensions in with other entitlement programs, the report states:

"Supporters of federal workers and retirees point out that these programs were integral parts of the employment contract between the federal government and its employees and therefore constitute earned benefits. Cutting them would probably hurt the government's reputation as an employer. Annual surveys comparing government and private-sector wages indicate that federal workers may be accepting lower cash wages in exchange for better retirement benefits in deciding to work for the government. In essence, these workers pay for their more generous retirement benefits by accepting lower wages during their working years. Moreover, as some observers maintain, cutting benefits promised to current workers may prompt forward-looking workers to demand higher compensation now to offset the increased uncertainty of their deferred benefits." (Footnote omitted.)

For whatever reasons, state and local government employees were kept out of the Social Security System for many years. These once excluded employees have built up their own systems, which work well for the overwhelming majority.

By contrast, for many years the Social Security System has been managed improvidently. The federal government has allowed retirees to reap where they have not sown, by drawing out of Social Security far more in benefits than their contributions and "earnings" on those contributions could support. Worse, the federal government has used the contributions of Social Security participants to pay current operating expenses rather than truly investing the money.

Now the Social Security System is in a hole. This is certainly sad news. But it is hardly "fair" to ask public employees to pay. Public employees did not create this problem.

If we were writing on a clean slate, with full knowledge of the consequences of operating Social Security like a lottery where everybody wins, until this is no longer possible, the nation would almost chose to adopt an approach much closer to the public pension plan system than to Social Security. Having gone down the wrong path for many years, it will be very difficult to now create a system of invested individual accounts, which is fair to young workers, without undermining the expectations of retired and soon to be retired Social Security participants, who would not have time to adjust to a new system.

There is, however, no reason to make things even worse than already are, by taking many millions of public employees out of their existing plans, which work, and adding them to the stock pile of unfunded federal liabilities.

At page 20 of its report, the Advisory Council puts forth, as one argument for mandatory coverage, that a high proportion of state and local government workers will receive Social Security benefits because of non-government work which they perform, or through their spouses. The Council report fails to acknowledge that State and local government employees do not receive any unfair advantage by remaining outside of the Social Security system for most, or part, of their career. In 1983, as part of the overall Social Security reforms enacted in that year, Congress adopted an anti-windfall rule, which has the general effect of reducing any Social Security benefit that the employee might otherwise be entitled to in accordance with a formula based on the period of time during which the employee was not covered by Social Security. This adjustment is made because Social Security is bottom weighted—-that is, Social Security tends to provide relatively high benefits for workers who have relatively low average career earnings. Another rule which is applicable to non-covered government workers, known as the spousal offset rule, reduces the spousal benefit which would otherwise be payable to these workers.

IV. Mandatory Social Security coverage has the effect of an unfunded mandate.

The effects of mandatory coverage on state and local governments would be serious. Those governmental entities which are now the most hard-pressed, such as large cities which have significant low income populations, would be the most severely affected.

The eventual cost to governments, when mandatory coverage is fully phased in, would be staggering. California, for example, would have annual costs of almost $2.3 billion. Ohio would be burdened with over 1 billion in additional cost, and Texas, Illinois, Colorado, Massachusetts, and Louisiana would have annual costs in the hundreds of millions. Even states like Washington, Florida, Georgia, and Connecticut, Michigan, Minnesota, and Missouri, which are not always thought as states having a high rate of non-covered employees, would face costs near, or exceeding, $100 million per year. On a new hires basis, the initial cost of mandatory coverage would be less, but even under this approach more than a dozen states would face first year costs in excess of $10 million.

As recently as March 12, 1997, bi-partisan representatives of the National Governors' Association testified before a joint session of the House and Senate Budget Committees, urging Congress not to enact federal tax cuts which would force state or local tax hikes. Mandatory coverage would be one degree worse, a federal tax hike which would also force state and local tax hikes.

V. Mandatory Social Security coverage is a new, regressive tax.

Mandatory Social Security coverage would be a new highly regressive tax, and would certainly be viewed that way by the middle class people who would pay it. Nationwide, the average earnings of a full time state or local public employee are approximately $31,850. The Social Security tax on this amount (6.2 percent) would be almost $2,000. An Illinois teacher would pay more for Social Security than for clothing or health care, and the Social Security tax, over $2,500 for an average teacher in this state, would equal almost half of his or her food budget. Currently the average Illinois teacher just about breaks even between salary and expenses.

Most public employees fall in the second and third quintiles of income. These are families whose average income ranges from about $20,000 per year to about $32,000 per year. Studies based upon CBO data and prepared by the U.S. House of Representatives Ways and Means Committee staff indicate that many of these families actually lost ground during the period 1977 through 1989, or, at best, have progressed only minimally. For example, the second quintile, those between the 20th and 40th percentiles in terms of average family income, actually lost about 1.7 percent in after-tax income, measured in constant dollars, during this thirteen year period. Those in the third quintile, between the 40th and 60th percentiles, fared somewhat better, but still realized income growth of less than a half a percent per year, uncomponded, throughout this period. Federal income tax rates, as a percentage of pretax income, actually increased slightly for the fourth income quintile group. (For the third quintile income group federal tax rates were essentially unchanged.). People at this level of income should not be called upon to pay additional taxes.

STATE TEACHERS RETIREMENT
SYSTEM OF OHIO
March 13, 1997

Mr. A. L. Singleton, Chief of Staff
U. S. House of Representatives
Committee on Ways and Means
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Singleton:

These comments are being submitted for the printed record of the Social Security Subcommittee of Ways andMeans hearing on "The Future of Social Security for this Generation and the Next" on behalf of the Ohio StateTeachers Retirement Board and the 300,000 active and retired members of our system.

Having carefully studied the January 6, 1997 report of the Advisory Council on Social Security, we strongly believethat mandatory coverage for all public employees will be a mistake and should not be a part of a reform packagethat claims to restore the financial solvency of the Social Security Trust Fund.

We urge your determined opposition to any proposal that would mandate Social Security coverage for new hiresor for any other configuration that could evolve requiring mandatory participation.

Ohio has a long history, predating Social Security, of providing retirement and disability security and familyincome protection to state and local public employees. When Social Security was initiated in the mid-1930s, Ohiopublic employees were not permitted to participate. Later, when states were given the option of joining SocialSecurity, Ohio voted to remain independent. Ohio public servants were already well-served. The Ohio publicretirement systems were and are stable and working well.

Mandatory Social Security coverage would hurt, not help, Ohio public employees. All Ohio public employees arecovered by a public retirement system. Unlike Social Security in which current workers are supporting retirees, theOhio STRS is reserve-funded. Ohio teachers fund their own future benefits. Today STRS is 81 percent funded. On a comparable basis, federal Social Security is funded at 5 percent or less. STRS is not dependent on governmentappropriations but is funded entirely by member and employer contributions and earnings from investments. Interest earnings provide 62 percent of the annual income today. Additionally, investments made by STRS andsystems like STRS throughout the nation make a powerful contribution to this country's economic strength andcontinued growth.

It would be a mistake to believe that those public employees who remained in public pension funds would not beadversely affected by mandatory coverage for new hires. Faced with the added cost of Social Security, it is almostcertain that Ohio would be forced to change existing public pension plans by adjusting benefits downward andperhaps even dropping retiree health care. The pool of money available to invest in our country's industrial baseand technological research would shrink over time as it was siphoned off to pay member benefits. From a publicpolicy perspective, it makes no sense to harm a system that is working well in an effort to temporarily fix SocialSecurity's problems. Furthermore, the enactment of mandatory coverage would produce an apparent unfundedmandate of immense proportions for Ohio taxpayers.

We appreciate the opportunity to comment on this important issue and would be pleased to provide furtherinformation if that would be helpful to you. Thank you for your consideration.

Sincerely,

HERBERT L. DYER
Executive Director